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### State, society and development: lessons for Africa?

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# **State, Society and Development: Lessons for Africa?**

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# **STATE, SOCIETY AND DEVELOPMENT: LESSONS FOR AFRICA**

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## **1. INTRODUCTION: STATE, MARKET AND SOCIETY**

During the 1950s and part of the 1960s development economists emphasised the role of government, or state<sup>1</sup>, in enhancing economic development. They argued that since less developed countries (LDCs) were severely confronted with problems of market failure and market imperfections due to lack of information and externalities, markets were not able to efficiently allocate scarce resources and co-ordinate individual decision making. The government should intervene in markets to overcome these market imperfections, since it was believed that due to better information about the economy as a whole the government could outperform the market in terms of allocating resources and co-ordinating decisions. Some academics and policy makers went even further in arguing that the government should control the entire economy and make use of planning models. In practice, governments of many LDCs intervened heavily in markets by way of, for instance, setting prices for many goods and services, subsidising domestic industries, imposing trade barriers, regulating financial markets, and keeping wages low. Moreover, a number of communist and other countries adopted the development planning approach.

Yet, the experiences of many LDCs with government intervention during the 1960s and 1970s showed that the government not necessarily outperforms the market in enhancing economic development. It turned out that in many cases government failure could be even more harmful to growth and development than market failure. This led to an

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<sup>1</sup> In this report the concepts 'state' and 'government' will be used interchangeably.

adjustment of the emphasis on the role of the government. Neo-liberal views – in which the role of the market as co-ordination mechanism is stressed – became increasingly popular. “Letting the markets work” was becoming the most central device of the critics of the heavy involvement of the government.

During the early 1980s many LDCs were confronted with major economic problems as the debt crisis unfolded. The IMF and the World Bank stepped in to assist these countries with reforming their economies. According to these international organisations one of the main underlying causes of the debt crisis was heavy government intervention. Therefore, in the reform programmes (Structural Adjustment Programmes, or SAPs) they attached to their financial support they emphasised the reduction of the role of government and the enhancement of the market as the major device for allocating scarce resources. These reform programmes clearly voiced the neo-liberal view, which became the dominant paradigm.

Since the mid-1980s, but especially during the first half of the 1990s, criticism of the IMF/World Bank grew as the reform programmes appeared to be extremely harmful to the poor in the LDCs, while at the same time they did not seem to reinvigorate economic growth. Apparently, according to these critics, letting the market work was not enough for attaining economic development. This led to bringing the state back into the debate. This was also stimulated by the increasing evidence that the government had played an important role in the economic success of several East-Asian countries. Both academics and policy makers stressed the importance of both market and government. The mainstream view was that the government should create the ‘right’ environment in order to let markets work and allocate resources efficiently. It should set ‘the rules of the game’. ‘Good governance’ became the concept to express this view of a government that guides the market to work efficiently. The 1997 World Development Report of the World Bank was entirely devoted to the role of the government and its relation to the market, expressing the interest of policy makers in the state-market relationship.

Yet, although most academics and policy makers seem to agree on the importance of both government and market in generating economic development, it remains a matter of debate what exactly should be the role of the government, to what extent markets should be liberalised, what are the rules of the game, and what exactly is good governance. The roots

of the answers to these questions lies in our understanding of what exactly is the government and what we mean by 'the market'. Moreover, we need to have more knowledge on how markets and governments function, and on the characteristics of the relationship between the government and the market.

With respect to this last issue, the concept of 'civil society' pops up in discussions recently. It is acknowledged that both the government and the market are embedded in society. The relationship between the government and the market seems to be dependent on the existence of a civil society. Civil society complements both the government and the market in their contribution to attaining higher economic growth. Rules of the game are important, but they should be supported by society. Interaction between the state, market and civil society – sometimes also termed 'the governance structure' – seems to be necessary, to both develop the rules of the game and create ways to guarantee implementation and respect of these rules. Civil society, which is comprised of free press, trade unions, etc., might provide the institutional and behavioural embodiment of respecting rules. It may help to guide and to screen the activities and outcomes of both the state and the market. In this context, attention is increasingly being paid to questions like the importance of having a democratically chosen government, the need for having well-established property rights, etc.

In this research report we aim at elaborating on at least some of the aforementioned issues. Apart from this introduction, the report contains two contributions that were presented at the seminar entitled *State, Society and Development: Lessons for Africa*, organised by the CDS on December 15, 1998. To be sure, this introduction and the two contributions will not explicitly go into the questions of how to define the government and the market. What we do aim at, however, is to discuss the concepts of civil society and governance and their role in stimulating economic development. Moreover, we focus on recent analyses of the role of governance and society in the development of Asian and Latin American countries and try to gain lessons from these countries' experiences for the economic development of the countries in Sub-Saharan Africa. We must stress, however, that we are not aiming for simple policy advice based on the experiences of other countries. Our goal is to try to formulate important questions with respect to the analysis of the role of

the state, the market and civil society in the process of development in Africa based on the experiences of the countries in other developing regions.

The remainder of this introduction is organised as follows. Section 2 briefly discusses the interest of the Centre for Development Studies of the University of Groningen in the issue of the relationship between the state, the market and society. Section 3 provides a summary of the contents of two contributions at the seminar. These contributions provide analyses of the role of the state, the market and civil society in the development of East Asian countries, Central and Eastern European countries. Section 4 aims at discussing the lessons from these contributions for the role of the state, market and civil society in the development process of Sub-Saharan African countries. This section also provides a list of issues on topics related to the interaction between the state, the market and civil society. Section 5 provides some concluding remarks.

## **2. THE CENTRE FOR DEVELOPMENT STUDIES AND THE DEBATE ON THE RELATIONSHIP BETWEEN STATE, SOCIETY AND DEVELOPMENT**

The significance of Civil Society is a core theme in the Groningen Centre for Development Studies' principal field of interdisciplinary study: *State, Society and Development*. Moreover, the activities of the Centre in general are strongly focused on Africa. This concerns scientific co-operation with universities in various African countries, for teaching and, increasingly, for research.

In this perspective, in February 1997, one year after the establishment of the CDS, an opening conference was held which dealt with State, society and ethnicity<sup>2</sup>. On that occasion, Naomi Chazan discussed the developments with respect to the peace process in the Middle East as opposed to the adverse developments in some parts of Africa, darkly coloured by the immense bloodshed in countries like Rwanda, Burundi, Eritrea, Ethiopia and other countries. These adverse developments took place in spite of high hopes after the demise of the Cold War.

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<sup>2</sup> See Hans Schoenmakers and Wiemer Salverda (eds.), *State, Society and Ethnicity in Developing Countries: Lessons from the 1990s*, Centre for Development Studies, University of Groningen, Research Report no 4, 1997, for a collection of the contributions made at this conference.

The next event organised by the CDS on related issues was a seminar entitled *State, Society and Development: The Lessons for Africa*, held on 15 December 1998. This time focus was on the role of the state, the market and civil society in the development of East Asian countries, Central and Eastern European countries and the lessons from these countries' experiences for the development process of Sub-Saharan African countries. The transformation in Europe and the economic success in Asia are relatively new and unique experiences that may differ from traditional approaches, such as the interventionist or the (neo-) liberal approach. These two approaches have been tried in Africa during the past decades without clear signs of success. Therefore, the new experiences in Europe and Asia might be fruitful in providing new insights on ways out of low development in most Sub-Saharan African countries.

### **3. SUMMARY OF THE CONTRIBUTIONS AT THE SEMINAR**

At the seminar in December 1998 one paper was presented that provided a general overview of the discussion on the role of the state versus the market, the importance of institutions for economic development and a discussion of the concept of governance and its importance for development. A second paper addressed the transformation process in Central and Eastern Europe and the role played by civil society.

The idea was to evaluate what lessons could be drawn with respect to the role of the state, the market and civil society in the process of development as experienced in Asia and Europe for the African continent. The current economic and political crisis in East Asia does not invalidate the experiences of these countries with respect to state interference and the state-society relationship and their contribution to the development process. To the contrary, the current developments may add important insights with respect to the dynamics of state-society relations during times of economic and political crisis.

At this point we need to stress that we are not aiming at looking for simple policy advice and policy rules that can be distilled from the experiences of other countries. The cultural, social, economic and political background of the African countries simply cannot be compared to those of the European and/or Asian countries. However, the analyses of the experiences of other countries may help to address the right questions and this in itself is



an important input in the process of analysing the role of the state, the market and civil society in the process of development in Africa. Below we shortly summarise the contents of the two papers.

Joachim Ahrens (University of Göttingen) in his paper “Toward a Post-Washington consensus: The Importance of Governance Structures in Less Developed Countries and Economies in Transition” challenges the IMF/World Bank policy recommendations by pointing out that they do not seriously consider the creation of institutions that are necessary to let markets function properly.

Ahrens starts with discussing the contents of the so-called “Washington consensus”, *i.e.* the intellectual background of the policy advice of IMF and World Bank to LDCs. The Washington consensus, which became dominant during the 1980s, is based on the neo-classical paradigm of competitive markets and stresses the importance of macroeconomic stabilisation, letting markets work and getting prices right, privatisation, trade liberalisation, rationalisation of government budgets and creation of the right institutional environment to let markets work properly. Emphasis is placed on the efficiency of the market and government should only contribute to creating the right environment to let markets work well. This view is radically different from the one that dominated during the 1950s and 1960s, when the general view on policy making stressed the importance of a government that intervened in markets and ‘got prices wrong’, in order to overcome existing market failures.

Ahrens’ critique of the reforms based on the Washington consensus is that while it stresses the need for institutional reforms in theory, it neglects the practical side of such reforms. Related to this point is that, according to Ahrens, in a way the policy prescriptions seem contradictory. While the government sector should reduce its scope in general, it should at the same improve its capacities and capabilities in order to be able to provide the right environment in which markets function well. This is no easy job, especially not in LDCs, where capabilities of the government are generally underdeveloped. Moreover, in the Washington consensus the government is a black box. There is no clear picture of how governments actually work. In order to advise countries on how the government should help market efficiency, however, one needs to open this black box. Ahrens points out that recent work from the New Institutional Economics and from political and sociological

scientists has contributed to opening up the black box. Therefore, advice on the role of government in improving market efficiency should make use of insights from these contributions.

Ahrens continues with a discussion of the concept of good governance. This concept has been introduced in discussions on economic development since the early 1990s. The problem, however, is that many different descriptions of what good governance actually is are found in the literature. Ahrens proposes to use the following definition: governance is "...the capacity of the institutional environment (in which individual actors, social groups, civic organisations and policy makers interact with each other) to implement and enforce public policies and to improve private-sector co-ordination". The institutional environment, consisting of formal and informal political, economic and social institutions, provides the incentive structure to economic subjects (politicians, citizens and business men) and determines the contents of relations between them. The incentive (or governance) structure is effective whenever it leads to sound management of public resources and the creation of an environment in which markets work efficiently. Policy reforms should be embedded in an adequate institutional environment. Moreover, this institutional environment should be susceptible to continuous change. Ahrens concludes that international organisations such as the IMF and the World Bank will be confronted with problems in the near future when advising LDCs on policy reforms that incorporate aspects of governance, since in many cases it involves politically sensitive questions and a coherent framework for policy advice with respect to governance issues is lacking within these institutions due to a lack of clear concepts and expertise.

Herman Hoen (University of Groningen) in his paper entitled "The Transformation of Economic Systems in Central and Eastern Europe: State, Society and Development" discusses the role of the state in the process of transformation in Central and Eastern Europe in order to extract lessons from these countries' experiences for African countries. In particular, he aims at discussing the conditions for having a 'powerful' state that is necessary to guide the process of economic transformation. Like Ahrens, Hoen also stresses the importance of the institutional environment: markets only work when supported by the right institutions. He argues that the state is responsible for guaranteeing freedom and enforcement of contracts, and for introducing and maintaining laws

supporting the market and market competition. Stated somewhat differently, the state should establish a clear and transparent set of general rules, or in the terminology of Ahrens a clear incentive, or governance structure. At the same time, Hoen argues, governments of most Eastern and Central European countries were unable to establish such rules given their weak internal organisation during the transformation. He illustrates his point by discussing the problems of taxation in most of these countries. So, a strong state is needed to establish the right and supportive institutional environment in order to make the introduction of a market economy successful. His definition of a powerful state is comparable to what Ahrens calls a 'strong but limited state'.

Hoen further argues that a strong state needs participation of the society in the policy decision making process. Without such participation the state is unable to identify the rules needed to let markets function well. Participation is best guaranteed by way of having a 'civil society'. Hoen discusses the definition of civil society. A clear definition is hard to find, but he seems to appreciate the description of civil society as the capacity of individuals to organise themselves voluntarily independent from the state, yet not necessarily without state participation. Civil society can be seen as the intermediate level where the state and the individual interact. In the context of Central and Eastern Europe Hoen argues that a negative definition of civil society has become popular in the sense that it reflected civil organisation against the state. In his view, organisations like 'Neues Forum' in former East-Germany and 'Solidarnosc' in Poland were in fact not part of a civil society, but were anti-political. He therefore rejects the view sometimes voiced that civil society in these countries was responsible for the collapse of communism.

#### **4. LESSONS FOR AFRICA?**

Often in science, getting the questions right is as important as providing the answers. Or to put it otherwise, it is often not so difficult to raise (a lot of) questions but establishing their importance is. This certainly holds in the case of the relationship between state, market and civil society and their role in the process of development. Below, we will discuss some of the questions raised at the seminar and add a number of observations

which can be grouped under two headings. First, the concepts state, market and civil society will be discussed shortly, their mutual relations and their role in the governance structure of a country. Second, the pros and cons of the universal validity of these concepts are considered. This helps to clarify what may be the lessons from Europe and Asia for Africa concerning the role played by the state, the market and civil society in the process of development.

### *State, market and civil society*

Although Ahrens and Hoen seem to agree on taking a broad perspective regarding the concept of governance – comprising the state, the market (or business sector) and civil society – , they both stressed different aspects of the state-market-civil society relationships. Ahrens focuses on the effectiveness of the governance structure, summarised in the concept of the strong-but-limited state. This boils down to a state binding its own hands vis-à-vis the business sector. Referring to the starting period of strong growth in South Korea, he points out that this self-chosen limitation of the state does rest on a kind of political control over the state exerted by wider circles in society, particularly democratic control. Unfortunately, however, he does not discuss the reasons for the government to bind its hands. Ahrens chooses to focus on the relationship between the state and the business sector and analyses this relationship in terms of its effectiveness for economic development. By implication, the author pays less attention to the role played by civil society.

In contrast, Hoen mainly focuses on the relation between state and civil society, opposing conflict to co-operation. Certainly, he does refer to economic reforms and discusses the effects of economic transformation on this relationship, yet the effects on the economy itself remain implicit. Thus, the two papers discuss different kinds of relations, *i.e.* the state-market relationship and the state-civil society relationship. Although both papers provide interesting insights with respect to both these relations, it should be noted that this does not mean that the relationship between the market and civil society can be neglected. Moreover, the approach taken in both papers holds the risk of separating the economic from the political context. Yet, in our view both aspects should remain closely linked in any analysis of the state-market-civil society interrelationships.

Hoen in his contribution has a point when he suggests that defining both civil society and the market as non-state does not really help. Without a positive approach we will be unable to discuss the mutual relations of the concepts, let alone the wider framework of governance into which they presumably fit. The identification in transition countries of the market as non-state (*i.e.* non-planning) may be only a temporary matter. This may be different for the concept of civil society, however. In the debate on the economic and political transformation of formerly socialist countries it is pointed out that the civil society – which materialised from a tradition of opposition to the state – may be swallowed by the new state. Consequently, this may leave a void in the state-market-civil society framework. This may lead to the risk of endangering the embeddedness of the state within the civil society. Exactly the same risk was put forward by Chazan and others during the debate on ethnicity and violence at the CDS opening conference (Schoenmakers and Salverda, 1997). The swallowing of civil society institutions by the new state may take place along the following two lines. First, institutions of civil society may disappear because there were only few of them and because they were basically anti-state. Second, the transfer of individuals that were the former leaders of these civil society institutions to the new state may inhibit the build-up of new civil society institutions that are needed to counterbalance the new state.

As was mentioned above, we will not go into discussing the concepts of state and market. Instead, we focus on discussing the concepts of civil society and governance. The discussion of the concept of civil society starts by evaluating the concept of ‘society’ and its relation to state, market and civil society. Few scholars would argue that either society and state, or society and market are non-overlapping concepts. Instead, society is generally thought to comprise of both the state and the market. However, few would say the same for ‘civil’ society. So, what does the addition of ‘civil’ to the concept of society really mean in this context? Which parts of society make up the civil society? We may safely say that there exists a two-sided relationship between civil society on the one hand and the state and the market on the other hand. It seems worthwhile to consider civil society as a concept with both a political as well as an economic dimension. Acknowledging the importance of both these dimensions of civil society is one of the interesting results of the recent debate on the role of the state versus the market. Moreover, the above mentioned

risk of a civil society being swallowed by the new state during the process of economic and political transformation may be all the greater if civil society has only a purely political dimension and when it becomes disconnected from the economic dimension of a society. In other words, embedding civil society in the economic and political sphere may contribute to the strength and continuity of the relationship between the state and the market. State, market and civil society relationships should be in balance. Figure 1 aims at illustrating this point.

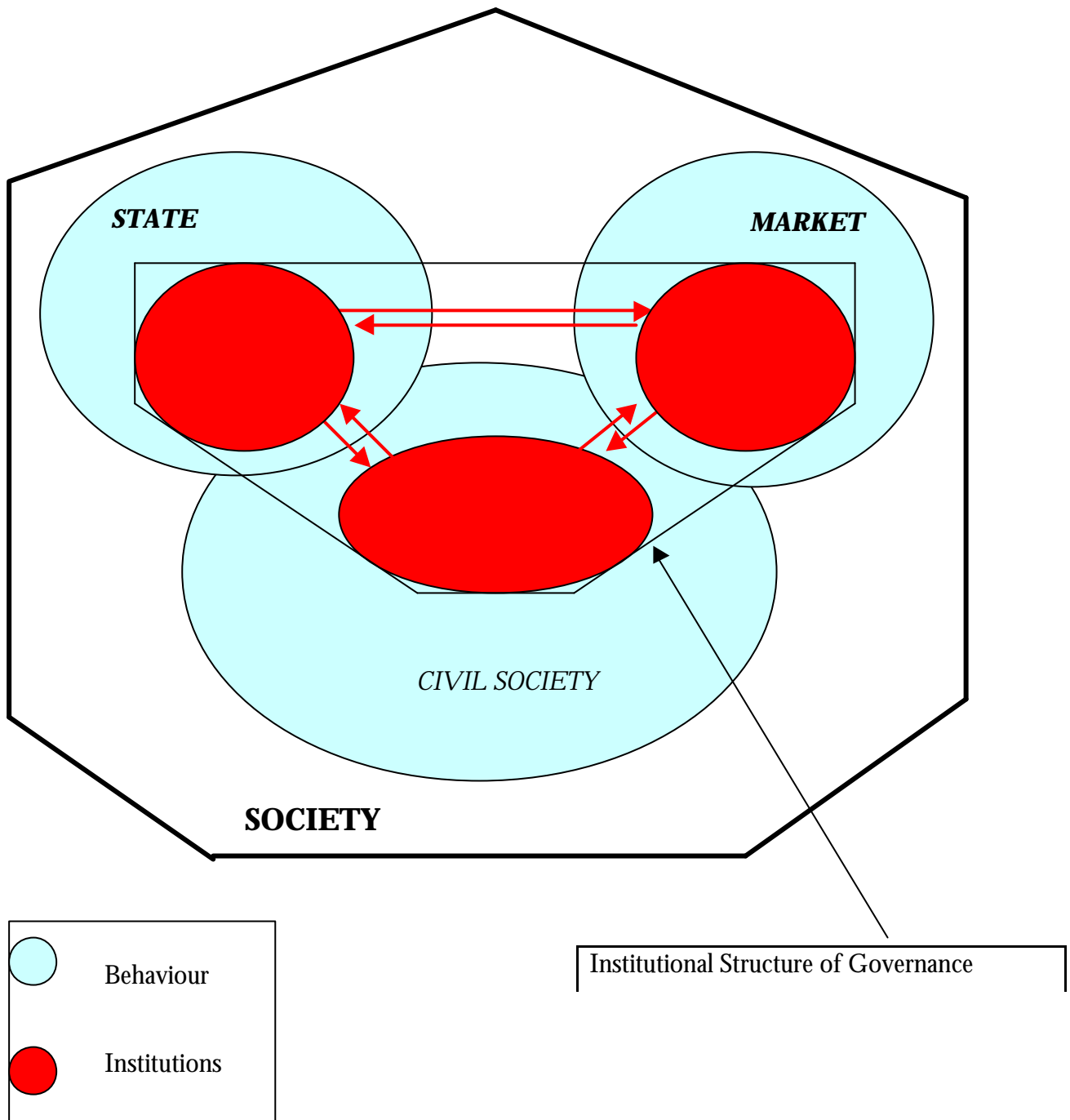
In our view, the state, the market and civil society share the need for rules or institutions. Without such rules the state, the market and civil society are unable to maximise their contribution to the process of development. This may become clear when we consider the following. Individuals should decline possibilities of rapid gain at the market place, *i.e.* the incentives for individuals to behave opportunistically should be reduced. It is often tempting to conspire and cheat in the market, because of the immediate gains that can be made. When cheating, individuals take advantage of asymmetries of information between partners. Yet, with opportunistically behaving market participants fewer transactions will take place, reducing the possibilities for efficient allocation of scarce resources. In other words, markets fail. In order to reduce the adverse impact of such behaviour legislation and/or other institutionally checks should be in place. The market can only efficiently allocate scarce resources when individuals obey to such formal market rules based on simple contract law. Defining and enforcing contracts may not be enough to create well-functioning markets, however. It seems insufficient to reduce the market to a guarantee of property rights. Property rights do not equate simply with a freedom of one's own ownership but imply the obligation to respect the property rights of others. This demands an extensive regulatory system of contract rules and an effective legal supervision of their observation. Markets may also fail due to misuse of power in relationships (*i.e.* corruption), rent seeking behaviour and the existence of externalities and related problems of free riding. Finally, the market outcome of the allocation of resources may be socially unacceptable. Again, institutions and rules are needed to correct for these market failures and obtain an economically optimal and socially acceptable allocation of scarce resources.

Yet, the state, the market and/or civil society cannot be reduced to a set of institutions. Individual behaviour is equally important and although behaviour relates directly to institutions – and vice versa –, it should be acknowledged that institutions alone cannot regulate all individual behaviour. Part of individual behaviour escapes the control of such institutions. Figure 1 illustrates this point. Each of the three elements in the figure – the state, the market and civil society – consist of institutional as well as behavioural aspects. They each have an institutional core that is unique and that, by implication, shows no overlap with the other two institutional cores. Taken together the three institutional cores may be said to form the institutional structure of a society's socio-economic governance. In contrast to institutions, individual behaviour – which complements the institutional core in all three cases – may (and indeed will) overlap between the three areas of the state, the market and civil society. Individual behaviour in this sense has a more universal nature. Individual behaviour belongs to a broader structure of governance within which the three areas and their institutional cores function. Thus, we want to stress that institutions and behaviour are indeed two distinctive elements of the governance structure, although we acknowledge that they are strongly mutually related. Both behaviour and institutions are needed to effectively contribute to the creation and working of a governance structure geared to economic development.

#### *Governance and civil society: universal concepts?*

Naturally, in the context of development, the discussion on civil society and governance is complicated by the reproaches of ethnocentricity articulated in the well-known debate on universal truths, on the value of democracy and human rights. However, there is more than that (but we will come back to this below). Also in the context of industrial countries, particularly the discussion on the role of institutions for unemployment illustrates that these countries have no uniform governance structure but instead, live with different institutional (and possibly even behavioural) set-ups that serve to establish certain basic institutions such as property rights in one form or another. Although at present unemployment outcomes differ internationally the outcomes at the overall level (GDP) are surprisingly similar. Apparently, local equilibria of institutions and behaviour have been

Figure 1: state, market and civil society



established that can explain this. As a consequence, discussions about ‘models’ seem to lead nowhere. Each time after long discussions, first on the ‘Swedish model’ and later on



the American, the Dutch, the Danish or the German model, the final conclusion is that it is very difficult, and maybe even impossible, to copy institutional set-ups from one place to another. In many cases this even holds for copying individual institutions from a broader set-up. The implication of this is that there is no such thing as a uniform structure of governance.

Notwithstanding the above remarks, the general debate on governance structures and civil society, and the efforts to draw conclusions from this about the possibly universal characteristics of these concepts, do have at least some important implications in the context of the process of development. One of the possible lessons from the debate on governance structures and civil society in the context of the East Asian countries is the fact that – to some extent and under strict conditions – market power is needed during certain stages of development. Such a concentration of economic power may lead to a higher level of investment in large projects and/or in projects with high spill-over effects. This is especially true in case market failures prevail and co-ordination of activities is called for through non-market channels. Conglomeration of activities then might be a way to overcome these market failures. The role chaebols have played in Korean development seem to illustrate this. However, it has also become clear that institutions like these chaebols need to be properly controlled and regulated, both by the state and civil society. Without such control and regulation, concentration of economic activities within these conglomerates could yield unwanted market power, which might turn into obstructing dynamic economic change and lead to a socially unacceptable allocation of resources. In that case, they might turn into a negative factor for growth and change during later stages of development.

Another observation about governance coming from the debate on the universality of the concept is that in a developing societies – much more than in industrial countries – the state may have to support the victims the market makes in the non-market economy. The poor need the support of the state in order to be able to acquire a place in society. Due to severe market failures in developing countries they often lack access to resources, like food, education, health, labour and credit. The state should correct for this lack of access. Again, the East Asian experience might hold important lessons. Many studies have pointed out the importance of emphasis on primary education for the development of these

countries. More generally, studies have shown that the relatively equal distribution of income has been a principal factor in the economic success of the East Asian countries.

Lessons from recent experiences with respect to the adverse role played by civil society must be taken into account as well, however. These recent experiences show that civil society may constitute a serious threat to young African states, especially in cases these states have been created rather artificially. Civil society may lead to the reviving of old ethnic quarrels that were subdued during the colonial period and after. A recent example of this from outside the African continent is Yugoslavia. Yet, several African states are experiencing similar problems, such as for instance Somalia, Rwanda, Burundi among other ones. Naturally, ethnic conflicts such as those experienced by the above mentioned countries have had (and will have) a strong negative impact on the economic sphere.

Finally, globalisation will certainly have its impact on the relationship between the state, the market and civil society at the national level. Global rules, conventions and institutions may increasingly come to dominate local ones. This may put important constraints on the development of domestic governance structures in African countries necessary to support the development process.

## **5. CONCLUDING REMARKS**

The debate on the role of the state, the market and civil society and their mutual relations in the process of development is just beginning to take shape. We welcome the increasing attention paid to these important issues in the international discussion and the literature. The debate on development is no longer monopolised by those who emphasise the economic aspects. It is acknowledged that political and societal aspects are important as well. Yet, many questions remain to be answered and we do not claim to have found answers on what role the state, the market and civil society should play in the development process of African nations. Rather, we have tried to summarise and discuss some of the interesting issues in the debate. Further research – also within the Centre for Development Studies – into questions related to the interrelation between the state, the market and civil

society is needed to address the questions put forward in this research report. This kind of research should have a multi-disciplinary character due to the many different dimensions of the relationships between the state, the market and civil society. In our view, the Centre provides the excellent soil to elaborate on the issues of the role of the state, market and civil society since the Centre connects researchers from various disciplines such as philosophy, law, political science and economics. The Centre will therefore actively stimulate interdisciplinary co-operation between researchers related to the Centre, and will also actively stimulate these researchers to do this kind of research with academics from outside the Centre.

# **TOWARD A POST-WASHINGTON CONSENSUS: THE IMPORTANCE OF GOVERNANCE STRUCTURES IN LESS DEVELOPED COUNTRIES AND ECONOMIES IN TRANSITION**

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## **1. INTRODUCTION**

The sobering experience with interventionist policies, which had characterised development politics after World War II, induced widespread disillusionment and was the starting point of a second wave in development theorising and politics in the late 1970s. The view of a benevolent state being capable of successfully steering the process of economic development came to be rejected, and the pendulum of opinion swung away from the strong confidence in the state toward the market.

Based on neoclassical economics and the public-choice school, the state was increasingly seen as a major obstacle to economic and social development. Bloated state apparatuses all over the world became the target of professional economists and multilateral financial organisations. Free markets appeared to be a panacea. Successful policy reform and sustained development seemed to require minimalist states. In the practice of policy reform, the new thinking in development theorising found its expression in the formulation of the so-called Washington consensus.

However, at the end of the 1980s and particularly in the 1990s, the debate on the role of the state reached a new quality. Political scientists, development practitioners, and economists recognised that the surge of the neo-liberal orthodoxy was self-limiting. Problems in the implementation of structural adjustment programs and emerging doubts whether structural adjustment itself was sufficient to spur future growth implied rethinking of the role of the state once again. Social scientists called for *bringing politics back in* and

initiated approaches to overcome the state-market dichotomy which had characterised the preceding discussions on policy reform. The emerging third wave in development theorising does not view the market and the state as mutually exclusive mechanisms of resource allocation, but rather seeks for complementarities<sup>1</sup>. This new strand of thinking has been strongly supported by new insights of the New Institutional Economics (NIE) on the one hand and the experiences of economies in transition and less developed countries (LDCs) on the other hand. Particularly, experiences in Central and Eastern Europe (CEE) reveal that market-oriented reforms will be ineffective, if they lack an adequate politico-institutional foundation. The pendulum of thinking about development has begun to swing back, but this time there is a chance that it will not return to the other extreme.

This paper takes the emerging consensus that economic reforms in most LDCs and economies in transition will be less effective or even doomed to fail without political change as its starting point. It elaborates on the impact of institutions on economic development and seeks to provide a coherent perspective of the role of the state in economic development by overcoming the alleged dichotomy of states and markets. By viewing failures in policy reform, poor public sector management, and rent seeking as systematic, though not exclusive, instances of institutional failure, this study seeks to contribute to the third wave. It looks for ways of constructing effective governance structures, which provide appropriate incentive systems to cope with such failures. No blueprint is offered, and answers to central questions can be specific to the context.

The remainder of the paper is structured as follows: The next section elaborates on the limitations of the Washington consensus. Attention then turns to the importance of institutions for economic performance and the role of the state in facilitating institutional change. Taking the interaction of the economy and the polity explicitly into consideration, a concept of governance is developed, that represents an appropriate institutional foundation of policy reform. Finally comes the question of a post-Washington consensus.

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<sup>1</sup> See, e.g., Streeten (1993 and 1996), Aoki et al. (1997), Evans (1995), and Grindle (1996).

## **2. POLICY REFORM, THE ROLE OF GOVERNMENT, AND THE LIMITS OF THE WASHINGTON CONSENSUS**

At the beginning of the 1980s, external shocks, particularly the debt crisis, hit the LDCs and contributed—along with underlying policy weaknesses—to economic stagnation, a decline in real per capita income, and macroeconomic instabilities. Numerous countries in Latin America, Asia, and Africa responded to these shocks by abandoning their state-led development strategies mainly based on import-substitution policies and embarking on market-oriented economic reforms emphasising privatisation and external liberalisation. By the end of the 1980s, even Post-Socialist Countries (PSCs) of Eastern Europe and Asia jumped on the bandwagon of policy reform in the course of their systemic transformation.

The new policy directions followed by most reforming countries essentially reflected a major lesson learned from the failures of interventionist policies and the following crises. Policy makers recognised that the dialectic interconnectedness of different policies affecting both the macro-economy and specific markets needs to be taken explicitly into account. Hence, the multilateral financial organisations, particularly the World Bank, strengthened their efforts to systematically encourage and assist stabilisation and structural adjustment in developing countries. Structural adjustment was seen as a process of market-oriented policy reform in order to overcome balance of payments problems, reduce inflation, and create the conditions for a sustainable increase in per capita income. Already in 1979, the World Bank introduced structural adjustment lending in order to support reform in policies explicitly aimed at reducing current account deficits, assisting countries in bearing the costs of structural change, and encouraging the inflow of external capital. Typically, structural adjustment includes macroeconomic stabilisation, liberalisation, privatisation, as well as deregulation.<sup>ii</sup>

The growing consensus on the economics of policy reform was mainly based on the neoclassical paradigm of competitive markets. Since the 1980s, the neoclassical approach has been the dominant factor shaping development economics and has performed an influential intellectual role in interpreting the state and the market as rival forms of resource allocation (Dutt et al. 1994). Derived from neoclassical reasoning, a supposedly necessary

and sufficient set of reform measures includes the following policy imperatives (Roemer and Radelet 1991):

- stabilisation (in order to correct imbalances in the balance of payments, government budgets as well as the money supply);
- letting markets work (so that free markets can determine prices);
- getting prices right (so that prices reflect scarcity values);
- privatisation (so that private property rights can unfold their beneficial effects for economic competition);
- budget rationalisation (in order to rationalise governments' reduced role in economic and social development);
- integrating the domestic economy into the world economy (in order to allow exports to become an engine of growth and to take advantage of the disciplining role of international markets);
- getting institutions right (so that governments are well equipped to carry out their new roles).

These policy prescriptions, to which mainstream development economists could generally subscribe, represented a sharp reversal of thinking about economic development. The emphasis was now on shrinking the scope and the size of government and to trust in the efficiency of market processes and private sector activities, which were regarded critical to fostering growth. Particularly, this New Orthodoxy required the state to withdraw from regulating and managing economic activities and to restrict itself to the classic tasks of providing law and order, a predictable and reasonable legal system, a stable macroeconomic framework, and improving health services, education systems, and physical infrastructure. State intervention in specific industries was considered to be irrelevant or even harmful and distorting for the allocation of resources. A role for government in *picking winners*—as postulated by revisionists and structuralists—was categorically rejected. This view received some modification, though no contradiction, when the World Bank (1991) proposed the market-friendly view, that sought to overcome the disputes of the neoclassical and revisionist interpretations of the sources of rapid growth

in East Asia. In its *East-Asian Miracle* study, the Bank (1993, 84) concluded “that rapid growth is associated with effective but carefully delimited government activism.” This view attributed a limited, but effective role to governments, which “is to ensure adequate investments in people, provision of a competitive climate for enterprise, openness to international trade, and stable macroeconomic management” (ibid.). Regarding selective government interventions in the High-Performing Asian Economies (HPAEs), the World Bank noted that less interventionist policy choices were more conducive to growth, although it admitted that policy makers need to exploit the complementarities between market processes and government activities. In that sense, rethinking state activism means less government intervention in areas where markets basically work or can be made working and more interventions in those areas in which market failures persist or markets do not exist. Another central insight was that economic policy making in the HPAEs—in contrast to numerous other LDCs which rigidly maintained unsuccessful policies—has been characterised by a high degree of *pragmatic flexibility* regarding governments’ attempts to use different policy instruments in their pursuit of (economic) policy objectives: measures which worked properly were retained, while those that failed were abandoned. Finally, the market-friendly approach highlights the importance of political stability and social consensus for successful reforms and emphasises the critical role of those institutions which determine the economic order, such as legal codes, property rights, and market entry and exit regulation. But after all, the World Bank continued to adhere to the New Orthodoxy despite these ramifications in its argumentation.<sup>2</sup>

The application of the general neoclassical principles needs to be tailored to the specific circumstances of individual countries undertaking policy reform. Depending on the initial conditions prior to reform, this concerns particularly the problems of sequencing and timing the reform process. In general, stabilisation is considered a prerequisite for structural adjustment. Theoretical considerations and practical experiences also suggest that a bold stabilisation-cum-adjustment program is preferable to gradual and partial reforms, which

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<sup>2</sup> For a distinct and illustrative critique of the World Bank’s *East-Asian Miracle Study* see Fishlow et al. (1994).



threaten to delay structural adjustment and to preserve persisting market distortions.<sup>3</sup> The substantial agreement, that has been widespread on the reform principles on which policy reform is to be based, induced a remarkable convergence of current fashions in development policy and led to a set of practical policy desiderata which are usually called for at the beginning of any policy reform process.<sup>4</sup> Williamson (1990b) compiled a corresponding list of policy actions and dubbed it the Washington consensus (see Box 1).

Box 1: <i>Elements of the Washington Consensus</i>	
<ul style="list-style-type: none"> <li>• Fiscal Discipline</li> <li>• Redirection of public expenditure priorities towards health, education, and infrastructure</li> <li>• Tax reform</li> <li>• Unified and competitive exchange rates</li> </ul>	<ul style="list-style-type: none"> <li>• Secure property rights</li> <li>• Deregulation</li> <li>• Trade liberalisation</li> <li>• Privatisation</li> <li>• Promoting direct foreign investment</li> <li>• Financial liberalisation</li> </ul>

Source: Williamson (1990b, 1994)

Triggered by widespread government failures as well as the macroeconomic crises of the Latin American economies in the 1980s, the Washington consensus is based on stabilisation-cum-adjustment policies recommended by the Bretton Woods institutions and US economic officials. It emphasises the need for prudent macroeconomic and financial policies, unified and competitive exchange rates, trade and financial liberalisation, privatisation, and deregulation. Implicitly, it calls for a minimal state that refrains from intervening in the economy and focuses on sound monetary policy, secure property rights, and providing primary education and infrastructure. These policy prescriptions appeared to be justified against the background of the economic crisis affecting Latin America in the 1980s. Then, partly resulting from weak public policies, markets did not function well.

<sup>3</sup> For discussions of key problems in sequencing and timing policy reform see, e.g., Edwards (1989), Corbo and Fischer (1995), and Martinelli and Tommasi (1997) as well as the references cited by these authors.

<sup>4</sup> See Williamson (1990a) and Rodrik (1996).

GDP was declining for several years. Budget deficits accounted for 5-10 per cent of GDP, and public expenditures were rather directed toward subsidising the inefficient state sector than used for productive long-term investment. Companies had few incentives to compete in the world market and to meet international quality standards. Initially, governments financed budget deficits by borrowing, especially from abroad, given relatively low real interest rates. In the course of the 1980s, increasing real interest rates in the United States put limits on continued external borrowing, increased interest payments, and forced many countries to rely on seignorage resulting in high and volatile inflation. Meanwhile, several countries, particularly Argentina, show remarkable records of successful stabilisation and now face the challenge to implement the second wave of reforms which are structural in nature. In contrast to LDCs in Latin America, countries in East Asia have always pursued relatively sound macroeconomic policies with budget surpluses and low rates of inflation. Hence, the sources of the current financial and economic turmoil cannot be attributed to a lack of fiscal prudence. Effective solutions to the current problems will not be found by solely relying on the Washington consensus (Stiglitz 1998a).

Certainly, most policy recommendations of the Washington consensus are essential to make markets work efficiently. They are easy to articulate and straightforward and focus on economic issues which are of critical importance. Yet, the policy prescriptions are incomplete and flawed for five reasons:

- (1) Focussing on inflation (which had been the most serious macroeconomic burden in Latin America) implied macroeconomic policies which may not be most appropriate for achieving long-term growth.<sup>5</sup> It has also diverted attention from other important sources of macroeconomic instability such as weak financial systems. Moreover, policy makers neglected other critical ingredients to a working market economy and sustainable long-term growth including competition policy, education policies, and policies to promote the transfer of technology and to improve transparency;
- (2) the call for state minimalism neglects the need for government intervention which results from the existence of externalities, scale economies, incomplete markets, and

imperfect information. Particularly in LDCs and PSCs, where market integration is weak and market imperfections such as the lack of functioning capital markets, technological and marketing spillovers, and co-ordination failures exist, market-enhancing government intervention, that complements and facilitates private-sector co-ordination is critical<sup>6</sup>;

- (3) the postulate of a minimal state also disregards the problem that it is state officials who would have to reduce the size of the state and the scope of its interference thereby putting their own interests, jobs, and values at stake;
- (4) the Washington consensus ignores the interdependence of the economy and the polity and hence the fact that economic institutions and activities are embedded in a complex fabric of social and political institutions; and
- (5) the consensus also neglects the institutional problems related policy formulation, implementation, and enforcement. Policy reform is not just a matter for technical experts to get the prices right. For the institutional structures underlying economic policymaking play a critical role in the direction of policy reform and the implementation of public policies.<sup>7</sup>

Therefore, the Washington consensus does not offer a blueprint for successful policy reform. Instead, the consensus raises new questions. Why are the recommended policies not heeded by governments of numerous LDCs and PSCs? If those policies are pursued (more often than not under pressure of the multilateral financial organisations), why do the expected outcomes not materialise? These questions need to be addressed by institutional analysis. On the one hand, they concern a country's political institutions and how these affect policy formation and bureaucratic implementation as well as the (institutional) interconnectedness between public agencies, private business, and civil

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<sup>5</sup> See Stiglitz (1998a) and the references therein for a more thorough discussion of why the prescriptions of the Washington consensus concerning stabilization and liberalization—its two core areas—are incomplete and even misguided.

<sup>6</sup> See Aoki et al. (1997), Rodrik (1995), and Stiglitz (1997)

<sup>7</sup> Policy makers base their decisions rather on political than on economic incentives. There is clear evidence that political factors often prevent authorities from realising reform programs in LDCs which, for economic reasons, appear to provide sound prospects for accelerating growth and improving living standards (Bates and Krueger 1993).

society. On the other hand, they are related to economic institutions such as contract enforcement and property rights.

The need for institutional reform, while basically acknowledged in theoretical proposals even of neoclassical provenience, was widely neglected in the practice of policy reform. When it was taken into account by policy advisors, economists and policy makers essentially focused on the institutional environment (law and order, a market-oriented legal system), but failed to give these reform measures a high priority on the sequencing agenda. Reforms of political institutions, however, have been almost completely neglected. While the political and social feasibility and sustainability of policy reforms are widely regarded as a crucial factor, this aspect is neither thoroughly discussed nor are recommendations elaborated to improve the politico-institutional foundation of economic development. The Washington consensus itself does not address either of these two areas of institutional reform.<sup>8</sup>

The internal organisation of state apparatuses is made up of a complicated nexus of institutions which provide incentives (and disincentives) for political decision-makers and bureaucrats to carry out public policies. In neoclassical models, however, the state is exogenous to the economic reform process. It is considered a black box which (usually unsuccessfully) seeks to solve problems arising in market processes. This perspective is largely inappropriate to deal with the *paradox of the adjusting state* which aggravates the problems of policy reform in LDCs and particularly in PSCs. This paradox concerns the ambivalent role of governments during the transition from a state-led model of economic development toward an open, market-oriented economy. While the state (i.e. the central government, subnational authorities, the legislature, and the bureaucracy) is postulated to withdraw from policy interventions and to perform a passive role, the transition usually requires nimble and robust political authorities to be in place that are capable of implementing and enforcing the new market-oriented policy directives. Performing this role is even more complicated if one assigns further market-enhancing tasks to the executive branch resulting from market imperfections. Making the state more effective so that it can meet new challenges and perform new roles in facilitating private-sector co-ordination is of

paramount importance for feasible and successful strategies of policy reform. This central issue, however, was not explicitly included in either the Washington consensus or any neoclassical approach to policy reform.

Experiences from transitional economies in CEE and the current financial and economic crisis in East Asia show that the surge of the neo-classical consensus has been self-limiting. Particularly the systemic change in CEE, which not only encompasses the stabilisation and restructuring of the economies but also a fundamental transformation of these countries' political systems and social fabric, reveals substantial shortcomings of the ahistoric neoclassical approach to policy reform. The prescriptions of the Washington consensus which have been applied to those economies in transition, which pursued a so-called shock therapy, proved to be insufficient and misguided in many cases, especially in the successor states of the former USSR. All of these countries (with the exception of the Baltic states) belong to the poorest performers in terms of both economic and political reforms. The negligence to get the institutional environment right at the beginning of the transformation process implied that private investors did not face stable expectations and that an efficient and socially accepted redirection of resources was hindered. Maybe more important, the failure to explicitly address the problems associated with the states' capacity and capability of initiating and implementing a politically feasible and economically effective set of reform measures aggravated the transformational recession in most countries.

Moreover, the stereotypical application of policy imperatives inherent in the Washington consensus to address the sources of the current financial and economic crisis in East Asia was misguided from the perspective of both the populations and governments of the affected countries themselves as well as numerous international observers. This is because the problems of the crisis did not result from a lack of fiscal or monetary discipline but were structural in nature. In most cases, governments pursued sound macroeconomic policies, but failed to establish adequate institutional arrangements to supervise and monitor private activities especially in the financial and banking sectors. Given these structural causes of the economic turmoil, the orthodox conditionality imposed by the IMF

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<sup>8</sup> A notable exception is the role of private property rights and an appropriate bankruptcy law, that has been acknowledged even by the advocates of the Washington consensus; see, e.g., Williamson

on these countries was exaggerated in the area of macroeconomic stabilisation and contributed to the severe political unrest especially in Indonesia.<sup>9</sup> If policy recommendations do not take their political and social consequences into consideration, they may prove to be counterproductive.

More generally, after a decade of structural adjustment policies, experiences in most LDCs were not encouraging. Outcomes of reforms did not meet the original expectations of either the donor community or the recipient countries. New lending programs had not materialised and domestic economic and social conditions continued to deteriorate. Furthermore, given increasing political instability, the tolerance of the recipient countries for the recipes of adjustment was declining, and lending organisations were facing increasing political resistance when they sought to impose further reform programs based on more rigorous conditionality (Frischtak 1994). Eventually, problems in the implementation of policy reform, existing co-ordination failures, economies of scale, and externalities in LDCs implied rethinking and redefining the role of the state in economic development. Since the end of the 1980s, the emerging new wave in theorising about economic development and thinking on the role of governments has sought to overcome the apparent market-state dichotomy. In order to better understand the past failures and present problems of policy reform, we need to go beyond the traditional debate over the proper roles of markets and states and analyse why neither lives up to the expectations of its advocates, how the performance of both can be improved, and how private sector co-ordination and government activities may complement each other.

Recent theoretical work of institutional economists has explicitly started to open the black box of the state and to focus on political behaviour and the role of institutions. By using the tools of the NIE as well as the insights of political scientists and sociologists, persisting deficiencies of the neoclassical model of policy reform can be overcome. This is because this strand of theoretical reasoning puts institutions at the centre of its analysis. The view that the state remains a central variable to economic development, structural change, and the process of policy reform inevitably raises the question of state capability and capacity. Grindle (1996) argues that political leaderships and structures, while often part of

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(1990b).

<sup>9</sup> See, e.g., Radelet (1998) and Radelet and Sachs (1998).

the problem, are necessarily also part of the solution to creating a more effective and responsive state. Recognition of the importance of state capabilities and capacities resulting from effective and durable politico-institutional structures and informal institutions is the central element of the newly emerging third wave of theorising about the role of the state in economic development. The utopian vision of the benevolent state as the ultimate promoter of economic development, proposed by the first wave, has proved to be unrealistic, but so have the optimistic expectations regarding free markets and minimalist states, which characterise the second wave.

### **3. INSTITUTIONS AND ECONOMIC DEVELOPMENT**

The analysis of institutions has become increasingly common in studies on economic history and development. It has profoundly improved our understanding of how economies develop through time (North and Thomas, 1973; North, 1990a). Economic and social development is no longer seen as an inevitable, though gradual, transition from local autarky toward specialisation and the division of labour. Instead, the process of development is regarded as being largely determined by the evolution of institutional arrangements which determine the terms of exchange between different agents. North (1995) argues persuasively that the institutional and organisational structure of a country is the primary source of economic growth and development. Economic growth occurs if the political and economic institutions provide relatively low transaction costs in impersonal markets, reduce potential hazards of production and trade (such as shirking and opportunism), facilitate capital accumulation and capital mobility, allow pricing and sharing of risks, and encourage co-operation. However, institutions can neither be taken for granted nor will they come automatically into existence from getting the prices right. Experience clearly indicates that efficient institutions, promoting economic growth and welfare, have been rare across space and time. Eventually, creating efficient economic institutions crucially depends on the existence of efficient political markets, because the polity specifies, implements, and enforces the formal rules of economic exchange. However, present knowledge about how to create efficient political institutions is limited.

If the polity in general and governments in particular represent crucial factors determining institutional change, an examination of the role of the state in economic development needs to distinguish between two analytical dimensions: (1) the state cannot determine how specific institutions will work, but it has the power to decide which formal institutions shall exist; through policy reform, the state changes existing and creates new economic institutions; (2) the state itself represents a complex nexus of institutions which provide the incentive structure of policy makers and determine the process of policy formulation, implementation, and enforcement. In a first step, therefore, the role of governments regarding institutional change is discussed. In a subsequent step, considerations focus on the importance of political institutions for establishing a secure politico-institutional foundation of policy reform.

### **3.1 Institutional Change, Policy Reform, and the Role of Governments**

Institutions are defined as the rules of the game in an economy and a society,

“the humanly devised constraints that structure human interaction. They are made up of formal constraints (e.g., rules, laws, constitutions), informal constraints (e.g., norms of behaviour, conventions, self-imposed codes of conduct), and their enforcement characteristics. Together they define the incentive structure of societies and specifically economies.” (North 1994, 360)

The most basic characteristics of institutions include that they are enforceable norms, rules, and behaviors which serve collective purposes and structure and constrain social interaction. They are known to the members of the relevant community or society and applicable in repeated and future situations. Institutions perform several socially valuable functions. They may facilitate economic exchange, induce human capital development, encourage technological change, and reduce the costs of transacting. But they may also support monopolies, thwart capital formation, and increase transaction costs. Generally, institutions provide the incentive structure of individual behaviour, that



determines individual choices and dictates the skills and knowledge which are expected to have the highest payoff. They reduce complexity by constraining the set of feasible actions, reduce uncertainty, and stabilise expectations. However, if institutions constrain individual choices too much, the opportunities and incentives of decentrally acquiring and distributing information and knowledge will be reduced. This, in turn, badly affects the desirable flexibility of individual action.

Basically, the functions of institutions can be classified according to the economising and the redistributive role they perform.<sup>10</sup> The former allows individuals to economise on existing transaction costs and hence to increase their utility within given constraints, or allows them to improve their personal welfare without badly affecting others. This does not mean that institutions generally benefit society at large. In fact, this motive is frequently overcompensated by the redistributive motive, i.e. the effort to improve one party's welfare at the expense of other parties. The economising function may be achieved by several distinct means, e.g., by relying on market or non-market institutions in order to exploit potential specialisation and external economies or economies of scale. Since appropriate institutions may differ in their effectiveness to perform the economising function depending on specific circumstances (and may yield different distributional effects), there exists a potential for institutional competition.

The relative importance of different institutional arrangements and the functions they perform change considerably in the course of development and particularly in times of major policy reforms. Economic and social backwardness of many countries, then, may be explained by persisting institutional inertia and rigidity and failing institutional adaptation to newly emerging technological, social, economic, and political challenges of development. Olson (1996, 19) had this in mind, when he wrote that

“the large differences in per capita income across countries cannot be explained by differences in access to the world's stock of productive knowledge or to its capital markets, by differences in the ratio of population to land or natural resources, or by differences in the quality of marketable human capital or personal culture. (...) The only remaining plausible explanation is that the great

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<sup>10</sup> This section particularly draws on Lin (1989) and Lin and Nugent (1995).

differences in the wealth of nations are mainly due to differences in the quality of their institutions and economic policies.”

Some economists argue that institutions, which exist in an economy and society, are efficient, because they are the outcome of potential or actual competition among alternative institutional arrangements (see Lin and Nugent 1995). In this context, the effective demand for institutional change is basically attributed to a change in transaction costs. The theory of transaction costs suggests that existing institutional disequilibria imply profitable opportunities for institutional innovation. Privately induced institutional change will occur if the marginal transaction costs of change are lower than the expected marginal benefits of the potential new institutional arrangement (Lin 1989). This reasoning implies that the demand for new institutions will trigger institutional change, and that new institutions will be more efficient than old ones. This conclusion, however, may be misleading for three reasons: (1) Due to free-rider problems, institutional change does not necessarily occur, even if a demand for institutional change exists; (2) even if a group of individuals voluntarily agrees on a new institutional arrangement the net benefits of which are expected to be positive for each individual, this arrangement will not necessarily enhance net *social* benefits; and (3) the interpretation of institutional change being efficient neglects the distribution of power within an economy; if, e.g., a single actor or a group of individuals is powerful enough to impose institutional change on another party, it can do so even if it makes the other party worse off. Since problems of collective action, the existence of externalities and co-ordination failures as well as an unequal distribution of power among private agents have typically hampered efficient institutional change in many LDCs, it is the state's role to intervene and to overcome this type of institutional failure and to facilitate the supply of socially beneficial institutions. In a broader context, this also holds for providing the conditions and institutions promoting technological change and supporting market-oriented macroeconomic and structural policies. Moreover, in the course of economic development, the existing institutions such as laws, norms, and property rights may become inefficient. Even if some inefficient institutions may be replaced through private initiatives, some will persist due to diverging social and private costs and benefits

and free-rider problems (Lin and Nugent 1995). Hence, governments can play a critical role in institutional adjustment and innovation.

Moreover, as Polanyi (1995/1944) argued forcefully, markets cannot unfold their socially beneficial effects if they are not embedded in a fabric of social relations. His argument is that markets can be only sustainable if they are adequately embedded in political and social institutions, which perform three critical functions comprising the regulation, stabilisation, and legitimisation of market outcomes. Rodrik (1998) emphasises precisely this point when he writes that

“every politician knows, the clamour for controls and restrictions overcome markets when markets produce outcomes that are not endowed with popular legitimacy. Markets are not self-regulating, self-stabilising, and self-legitimizing. That is why every functioning society has regulatory bodies that set the rules of competition, monetary and fiscal institutions that perform stabilising functions, and social insurance schemes, transfer policies, and other social arrangements that bring market outcomes into conformity with a society’s preferences regarding the distribution of risks and rewards.”

The preceding arguments show that the state needs to play a critical role for sustainable and socially beneficial institutional change. After all, the state provides a framework of order on which the economy is built. By undertaking policy reform, the state changes existing and creates new institutional arrangements, even if policy reform merely includes those measures advanced by the Washington consensus. Furthermore, due to imperfect information, incomplete markets, imperfect competition, and transaction costs, the state can potentially become an important catalyst for economic development. However, this does neither imply that governments will inevitably initiate the desired change nor that policy reform is bound to succeed. Governments have not only often failed when they conducted wrong policies, but also when they did too much or too little about the right policies (Lin and Nugent 1995). Developmental states, therefore, require a politico-institutional foundation that provides policy makers with the incentives and the ability to design and institute institutional arrangements conducive for growth and development,

which a privately induced innovation process fails to provide. Not the minimal state, but the *capable state* is needed in order to make market-oriented policy reform a stable and viable policy choice.

### **3.2 The Need for a Politico-Institutional Foundation of Policy Reform**

Differences in economic performance between LDCs and industrialised countries on the one hand and among LDCs on the other hand eventually result from the established economic and political order and the policies pursued by governments. The efficacy of both factors is crucially determined by underlying institutions and particularly by the interplay of economic and political institutions. These are essentially old problems which have been already recognised by the students of classical political economy and political philosophy such as Locke, Montesquieu and Hobbes.<sup>11</sup> However, few of their insights have been incorporated into modern economics and influenced economic advisors to LDC and PSC governments. Recently, works of the NIE have been extended to the economic analysis of political institutions which may be defined as those formal rules and informal constraints (including their enforcement characteristics) that directly affect political decision-making processes in the course of economic development.

The importance of applying analytical techniques from the NIE to politics and hence addressing the problems concerning the role of political institutions for economic development and policy reform is clearly revealed by the problems of economic transformation and democratic transition in LDCs and particularly in CEE. Usually, advisors focusing on economic transition urgently request governments to get the prices right. Although this is a critical issue of economic reforms, this advice is not sufficient to ensure a successful transformation. Many governments face political and social constraints which hinder them to implement bold market-oriented reforms. If, e.g., private interest groups have a strong influence on policy making, economic policies may show a significant bias favoring special interests and do not benefit society as a whole. Even if governments initiate policy reform with a suitable policy mix based on an adequately specified set of

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<sup>11</sup> See Weingast (1993) for an instructive elaboration.

economic institutions, economic development might be impeded by political risks resulting from uncertainties about government behaviour in the future. As the experiences with failed policy reforms in LDCs indicate, proper advice regarding the formation of policy reform needs to account for the relationship between the economy and the polity. Emerging markets not only require well functioning economic institutions such as private property rights, a rational price system, and a well defined law of contract. They also require a secure political foundation that allows the formation and implementation of economically and socially necessary reforms.

However, as North (1990b, 361) argues, “(i)mperfect models of the complex environment that the politician (and constituent) is attempting to order, the institutional inability to get credible commitment between principal and agent (...), the high cost of information, and the low payoff to the individual constituent of acquiring information all conspire to make political markets inherently very imperfect.” Political markets are usually neither perfectly competitive nor efficient. Different politico-institutional arrangements will imply different political transaction costs and result in different political outcomes. The ability of the state to promote institutional change that benefits the economy as a whole crucially depends on the institutional structure of the polity and hence the incentives faced by policy makers—an aspect usually neglected by economic analysis. Transaction costs also exist within the political apparatus and affect the relations between the electorate, business elites, and the government. The interaction of the government, legislatures, state agencies, and society is constrained by political and social institutions. Economic outcomes are not only responses to market conditions, but also the products of these institutionalised relations (Dixit, 1996; Evans, 1995).

Therefore, a thorough analysis of the proper role of the state in economic development needs to overcome the oversimplified treatment of the state as a monolithic organisation. Max Weber (1972/1921) defined the state as a compulsory association that successfully claims the monopoly of the legitimate use of physical force within a specific community. Contemporary scholars usually view the state in the Weberian tradition, but attempt to usefully amend this definition by reducing the complexity of analyzing what states do and what roles they perform. In its definition of the state, this study essentially follows the perspective on the state outlined in Evans, Rueschemeyer, and Skocpol (1985)

and Grindle (1996). Thus the state is seen as an organisation based on a nexus of institutions for social control, authoritative policy formation and implementation, in which policy makers and social actors interact with each other and influence the path of economic, social, and political development, which in turn shapes the behaviour of individuals and groups.<sup>12</sup>

When institutions and economic policy are seen as the focal points of the development problem, attention needs to focus on the behaviour of politicians and political parties, bureaucrats, interest groups, and voters. The rational-choice approach to politics, advanced by the public choice school and positive political theory, suggests that political institutions can be explained as outcomes of purposeful human choice. The opportunity to rationally craft institutions, however, does not imply that the developed new rules are efficient either from an individual or a societal perspective. Since the future is open, random events cannot be ruled out, and the actual consequences of institutional transformation cannot be exactly predicted. Like every economic decision, the human design of institutions is subject to uncertainty. But the importance of explicit institution building has been stressed by political economists as an unalterable prerequisite for successful policy reform, particularly concerning the transformation processes in PSCs. In this regard, formal institutions, which are to be enforced by the state, represent devices that are used by governments for overcoming problems of collective action and for steering the economy and the society as a whole. This implies essentially three problems resulting from the bounded rationality of policy makers, asymmetric and incomplete information, and the difficulty of politicians to credibly precommit to specific policies:

First of all, government intervention into the fabric of formal institutions may be an unalterable prerequisite for policy reform; e.g. if a new constitution needs to be established in the course of the transition from socialism to capitalism or if reforms of the legal system must be undertaken to support the adjustment of an economy to a changed political, social or international environment. However, changing formal institutions implies the danger that *fundamental* institutions are unconsciously changed which are embodied in the existing

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<sup>12</sup> In this study, states are distinguished from administrations and regimes, but not from governments. For a definition of the term *regime* see Grindle (1996, 4).

laws and regulations.<sup>13</sup> Governments often show an excessive propensity to political constructivism. But the ultimate consequences of institutional intervention may become so complex that they cannot be fully anticipated. Also, due to the relatively high stability of informal institutions, the possibility to control social processes through formal institutions is rather limited. If policy makers neglect this side condition, they run the risk that informal institutions and formal rules contradict each other thereby reducing the growth potential of an economy.

Secondly, in initiating and facilitating institutional change, policy makers need to recognise the strategic uncertainty of rule making. This is because other actors such as private households and businesses as well as organisations of the civil society whose welfare and behaviour are affected by institutional change will generate feed-back effects on policy choices and new institutional arrangements. Since policy making cannot be regarded as a game of perfect information with only two moves, a government changing economic or political rules needs to be capable of anticipating the reactions of other parties and the induced effects on the credibility of public policies.

Thirdly, and related to the foregoing, politicians, who reflect multiple interest groups, cannot succeed acting alone, but need to make agreements with other policy makers, business elites, and social groups with different interests. Since future payoffs of alternative political choices are unknown *ex ante*, policies can be effectively implemented today only if credible commitments are made for future decisions. In order to reduce the costs of political bargaining, legislative exchange, and policy implementation, institutional arrangements must be put in place which facilitate the exchange over both time and space. They need to constitute *ex ante* agreements concerning the cooperation among different policy makers and between them and private business as well as important groups of

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<sup>13</sup> Fundamental norms and rules are the outcomes of long-term evolutionary processes, and individuals usually comply with them unconsciously, because they have been internalised in the wake of human socialization processes. Intentionally changing these fundamental institutions exceeds the human capabilities. They embody more knowledge than any individual or agency could ever achieve. Numerous fundamental *informal* institutions have been formalised and embodied in constitutions and laws. Hence, originally unintended institutions assumed the character of conscious intent by legal formalization. While informal rules cannot be intentionally transformed, fundamental formal institutions can be basically changed overnight. However, due to their complex nature, an intentional intervention into the fabric of fundamental formal institutions may be socially more harmful than useful.

society.<sup>14</sup> In order to facilitate private-sector co-ordination and to foster economic growth, politicians and bureaucrats have to rely on the private sector, which is expected to provide reliable information and to increase private investment. Therefore, authorities need to establish institutions which constitute governments' credible commitment to deliver their promises to business and non-elites.

A credible government commitment, generally recognised as a necessary condition for successful policy reform<sup>15</sup>, is not necessarily based on reputation, ideologies, partisanship, individual backgrounds, or repeated play. Instead, recent research has found that political credibility results from three conditions the satisfaction of which is significantly facilitated by specific institutional foundations.<sup>16</sup> These determinants include the sincerity (or truthful revelation) condition, the capability condition, and the sustainability condition. All three components are necessary conditions for credible political commitments. First, recall that *actions speak louder than words*. Even if a government is able to implement reforms policies, a lack of sincerity or truthfulness of political decision makers, who support reforms by words, but not by deeds, is sufficient to ensure reform failure. Second, even if policy makers truthfully reveal what they actually mean, reforms will be doomed to fail and promises will be regarded as incredible, if the government lacks the capability of technical implementation and of forming appropriate legislative and enforcement coalitions. Third, even if pivotal political actors are sincere and capable, policy reforms will fail, if they cannot be sustained over time in the course of government changes or exogenous shocks. This implies that the three conditions are individually necessary and collectively sufficient to make political commitments believable.

Lupia and McCubbins (1998a) found that specific institutional arrangements, within which a pivotal political actor makes promises to the citizenry or a policy statement in negotiations with international organisations, can serve as substitutes for his personal attributes with respect to sincerity. An appropriate institutional context needs to increase opportunity and transaction costs for breaking, revising, or reneging on promises (e.g.,

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<sup>14</sup> For a related argument see North (1990a).

<sup>15</sup> See, e.g., World Bank (1995) and Lupia and McCubbins (1998a).

<sup>16</sup> The analytical framework, on which the following considerations are based upon, has been developed in Lupia and McCubbins (1998a and 1998b).



through bonding or signaling mechanisms<sup>17</sup>). Furthermore, in order to satisfy the capability condition, specific institutions are required to ensure technical capability of implementing reforms (e.g., a competent and meritocratic public administration and bureaucratic procedures and administrative law setting the terms of delegation) and to ensure the effectiveness of a legislative and enforcement coalition (e.g., appropriate agenda control mechanisms and suitable institutional arrangements for the creation of ministerial positions and committees). Finally, in order to ensure sustainability of reforms, institutions need to be in place which can protect policy reform beyond the enacting government's or political leader's reign of power (e.g., veto gates in the governmental process and deliberation councils).

These problems underscore that institution building may turn out as a two-edged sword. The ability to change old and to craft and adopt new institutions is a necessary precondition of successful development management. However, the risk to induce unanticipated institutional disequilibria and economic distortions or to encourage pork-barrel politics resulting from too many institutional veto points<sup>18</sup> is always inherent to politically imposed institutional change. Policy makers need to be aware of both the risks and the benefits of institution building and specifically rule making if they seek to actively steer economic and social processes.

#### **4. ON THE CONCEPT OF GOVERNANCE**

An economy's ultimate success in narrowing the gap between its actual and potential rate of development critically depends on the political leadership's commitment and ability to implement and enforce appropriate policies. Inadequate quality of economic management represents, according to Meier (1995, 65), the super constraint to moving toward a higher trajectory of development. However, as yet, the practice of policy reform, i.e. the process of replacing inefficient by effective policies and the creation of effective

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<sup>17</sup> Effective signaling, however, may be a costly effort and imply a policy-overshooting in order to make reforms credible; see Rodrik (1989).

management capacities, is not sufficiently understood. Since policy makers base their decisions rather on political than on economic incentives and dominant groups in society as well as public officials are all too often inclined to extracting rents from established policies, there is a lack of incentive-compatibility of government policies and economic performance in many LDCs. What appears to be feasible politics does not necessarily turn out to be good economics. For that reason, students of economic development have been pessimistic regarding the opportunities for policy reform (Grindle and Thomas 1991). Addressing this problem requires to explicitly study the *political institutions* related to development management. Taking the institutional structure of the political sphere into consideration implies a differentiated understanding of the political economy of policy reform.

Political scientists and development economists have repeatedly found an intriguing combination of state strength and state weakness which characterises numerous countries in the developing world. On the one hand, most LDC states have been excessively powerful in regulating the economy and directly interfering in economic activity and social behavior. On the other hand, they have been chronically unable to enforce tax laws, resist pressure from interest groups, and implement coherent market-oriented reforms.<sup>19</sup> And yet, some LDC governments had been capable of committing themselves to an active, and sometimes even effective, promotion of national objectives, which did not favor any particular group in society and often contradicted the interests of powerful pressure groups. The emergence of these *developmental states* has been acknowledged in the literature.<sup>20</sup> But, as yet, their institutional, political, and social determinants have not been fully understood.

The disappointing experience with adjustment policies has begun to draw the attention of economic policy makers and international donor organisations to the puzzling questions about the logic of government behaviour and the institutional foundation of a

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<sup>18</sup> Cox and McCubbins (1997) persuasively argue that too many veto points, which are controlled by political actors with diverse interests, imply state indecisiveness and may increase the government's responsiveness to special interest groups.

<sup>19</sup> See Frischtak (1994). In reality, of course, LDC states differ considerably with respect to the dimensions recorded here as weakness and strength. To simplify the argument, this paper follows Frischtak (1994) and uses the Weberian ideal-type of state as a reference model. Thus, the analytical model of the state, used here, does not result from empirical characteristics of any LDC state and may be tested only regarding its conceptual suitability.

<sup>20</sup> See, e.g., Leftwich (1995), Huff (1995), and Evans (1989 and 1995).

developmental state. In order to conduct effective adjustment programs, LDC governments need to assume roles the capacity and capability for which they have typically lacked. The challenge to reform the state is complicated by an increasing scarcity of available financial means which prevents governments from avoiding political opposition and conflict by using public resources (Frischtak 1994). The paradox of the adjusting state precisely reflects its lack of institutional, administrative, technical, and political capacities. Regardless of whether a government decides to follow the policy recommendations of the Washington consensus or whether it opts for a more activist role to overcome co-ordination failures and other market imperfections, a complex politico-institutional structure needs to be put in place in order to make government more effective in accomplishing whatever tasks it undertakes. Such institutionalisation, however, cannot be taken for granted.

Effective policy reform not only requires credible commitments that political promises are actually delivered to citizens, but it crucially depends on the administrative capacity of state institutions and the technical and political capability of policy makers in order to fit the roles which the political leadership seeks to pursue. In this regard, the governance structure underlying the process of policy making is of utmost importance.

Until the beginning of the 1990s, the term *governance* was rarely used by development economists. Since then, however, there has been an increasing realisation that the quality of a country's governance structure is a key determinant of its ability to pursue sustainable economic and social development. But as yet, a clear and operational definition of the term, agreed upon by a majority of scholars and policy makers, has not been formulated. At present, there is a confusing variety of definitions which greatly differ with respect to issues, problems, or objectives that are taken into account (see Box 2). Often, the term is used as a catchphrase in political discussions, and users of the term either do not offer any definition or seek to incorporate too many aspects so that the underlying concept turns out to be useless.<sup>21</sup> Some definitions prove to be completely redundant, e.g., if governance is perceived as *good government*.<sup>22</sup> Other uses of the term highlight several

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<sup>21</sup> This holds, e.g., if the term *good governance* is supposed to mean promoting sustainable economic and social development, democratization, participatory development, fostering the enforcement of human rights, and improving environmental standards; see, e.g., Leisinger (1995).

<sup>22</sup> This definition simply creates a new term without providing any new conceptualization. What it makes particularly problematic is the use of the adjective *good*, which only reflects subjective perceptions.

substantive characteristics of a governance concept but do not offer a proper definition. The recent literature on obstacles to structural adjustment addresses several critical elements for a suitable conceptualisation of the term, but does not explicitly refer to the notion of governance.<sup>23</sup> Some scholars interpret governance as an end in itself, while others see it as an analytical frame or as a means to promote sustainable development (Kjaer 1996).

Box 2:	<i>Definitions of Governance</i>
	<ul style="list-style-type: none"> <li>• Governance capacity is defined “as the ability to co-ordinate the aggregation of diverging interests and thus promote policy that can credibly taken to represent the public interest” (Frischtak 1994, vii)</li> <li>• Governance is “an interactive process by which state and social actors reciprocally probe for a consensus on the rules of the political game.” (Bratton and van de Walle 1992, 30)</li> <li>• Governance means “identifying economic and social objectives, and (.), charting a course designed to move society in that direction.” (Boeninger 1991, 1)<sup>24</sup></li> <li>• “Governance (...) is the conscious management of regime structures with a view to enhancing the legitimacy of the public realm.” (Hydén 1992, 7)</li> <li>• Governance is the “capacity to establish and sustain workable relations between individuals and institutional actors in order to promote collective goals.” (Chazan 1992)</li> <li>• Governance signifies “the capacity to define and implement policies.” (Kjaer 1996, 6, emphasis omitted)</li> </ul>

Many approaches seek to conceptualise the term by addressing aspects which are critical from the perspective of policy reform, but the underlying definitions remain vague and hardly operational for practical matters. This is, e.g., the flavour of the definition used by the World Bank (1992, 1) which defines governance according to Webster’s Dictionary<sup>25</sup> as

<sup>23</sup> See, e.g., Bardhan (1995), Streeten (1993), Boycko et al. (1996), and Martimort (1996).

<sup>24</sup> Quoted in Doornbos (1995, 383).

<sup>25</sup> See Webster’s New Universal Unabridged Dictionary, London: Dorset & Baber, 1979.

“the manner in which power is exercised in the management of a country’s economic and social resources for development. Good governance (...) is synonymous with sound development management.”

A more instructive interpretation of the term is offered by the Institute On Governance (IOG), a consulting firm located in Ottawa/Canada. For the IOG,

“(g)overnance relates to a complex system of institutions, actors, traditions and systems involving the state, civil society and the private sector—and not simply government—on matters of public concern. (...) Governance has to do with the institutions, processes and traditions for dealing with issues of public interest. It is concerned with how decisions are taken and with how citizens (or stakeholders) are accorded voice in this process. The need for the concept of governance derives from the fact that today, government is widely perceived as an organisation. In its early form government was seen as a process whereby citizens came together to deal with public business ... Today, government is viewed as one of several institutional players, like business or labour, with its own interests. ... The emergence as government as a freestanding organisation in society with its own agendas and interests has created the need for a word to describe a process distinct from government itself.”<sup>26</sup>

A more operational definition, that will be suitable to improve the practice of policy making in LDCs and PSCs, may be derived from conceptual considerations, which address key issues of policy reform.<sup>27</sup> One conceptual approach to governance views democratic government as an unalterable prerequisite for successful adjustment. In that sense, good governance corresponds to democracy, that keeps government small and ensures that economics dominates over politics. Due to the historical experiences of industrialised countries and the assumption that democracy may provide a remedy against a big and potentially corrupt government, democratic institutions and processes are regarded as

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<sup>26</sup> Martin (1998, 1, emphasis omitted).

<sup>27</sup> The following considerations on the conceptual use of the term essentially draw on Frischtak (1994).

effective devices to secure thriving markets. However, the concept of democracy seems to be too broad for a proper operationalisation. Furthermore, the derived thesis that democracy will automatically foster economic growth and development is empirically not well supported.<sup>28</sup> Hence, one may agree with Frischtak (1994, 12-13), who states that “(t)o build attributes to specific political regimes into the very concept of governance—quite apart from the fact that these attributes and norms may be worth promoting in their own right—detracts from the analytical utility and credibility of the concept.”

Another conceptual underpinning to governance identifies the institutional capacities of state apparatuses as the crucial constraint to successful policy reform. This approach overcomes the debate on big versus small government and, instead, focuses on specific characteristics of the government machinery such as autonomy, rationality, efficiency and technocratic capability which make public administrations less dependent on the disruptions of politics. Indeed, institution building has been increasingly recognised by the development community as a key ingredient of policy reform. This conception highlights some of the key constraints faced by adjusting states. But it will unfold its inherent potential to improve our understanding of the political economy of policy reform only if it can (1) succeed in identifying the conditions which will allow states to develop the required institutional capacity; and (2) adequately incorporate state-society relations in its analytical framework.

The third conception worth noting adds the dimension of informal institutions (culture, habits, traditions), which shape individual behaviour and subjective perceptions, to the governance framework. This conception has been particularly influenced by experiences from Sub-Saharan Africa, where artificially imposed political institutions as well as externally imposed standard development strategies were often interpreted as the root cause for the long lasting crisis of governance and resulting adjustment failures.<sup>29</sup> The policy prescriptions inherent to this approach include that both development strategies and reform policies ought to be compatible with cultural characteristics and that effective governance needs to take the belief systems persisting in society into consideration (North

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<sup>28</sup> See, e.g., de Haan and Siemann (1995).

<sup>29</sup> Frischtak points out that this conception may also reflect the positive development experiences of countries such as South Korea and Japan, which succeeded in modernising without giving up their cultural traits.

1992 and 1995). With respect to Sub-Saharan African countries, this conception would advocate the transition from strongly hierarchical, state-centered polities toward organisational arrangements which encourage self governance of local communities and strengthen non-governmental organisations. This line of reasoning adds an important aspect to the discussion on governance, which has been usually neglected by the economics profession. It also implies that, because development is path dependent, there is no universal model of effective governance to be successfully applied to all LDCs and PSCs.<sup>30</sup>

Last but not least, a fourth conception, which is closely related to problems of policy reform, views governance as an approach that comprises the establishment of abstract, universal rules, their enforcement mechanisms, as well as stable and transparent mechanisms of conflict resolution. This conception refrains from making any normative judgment concerning specific political regimes and rather follows Weber's (1972/1921) notion of the modern state. Weber proposed that the operation of markets requires a high degree of calculability based on legal rationality, the rational administration of justice, and a relatively insulated bureaucracy (characterised by a functional definition of duties and full-time devotion to administrative tasks), the work of which is not only based on instrumental rationality, but essentially on the development and enforcement of universal legal norms. Similar to Weber, who conceived that his ideal-type of state is most conducive to the functioning of modern capitalist societies, this conception also suggests that its notion of governance is the key to creating an enabling environment for policy making and business activities.

The definition of governance which is considered as appropriate for the purposes of this paper is based on the conclusions which can be drawn from the above conceptions. Hence, governance is defined as

the capacity of the institutional environment (in which individual actors, social groups, civic organisations and policy makers interact with each other) to implement and enforce public policies and to improve private-sector co-ordination.<sup>31</sup>

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<sup>30</sup> Regarding the cultural dimensions of governance in an African context, see Martin (1992).

In that sense, governance per se is neither good nor bad. But in its concrete form, a governance structure, i.e. the underlying institutional environment (comprising formal and informal political, economic and social institutions) as realised in a particular country, may promote the efficacy of policy reform or prove to be harmful for economic and social development. A governance structure affects the incentives of politicians, bureaucrats, and private economic agents alike and determines the terms of exchange among citizens and between them and government officials. This implies that the capacity of an existing governance structure plays a key role with regard to (1) the formation, implementation, and enforcement of economic and social policies as well as development projects; and (2) private sector development and co-ordination. A governance structure is *effective* if it ensures that policies and projects conducted by governments are properly implemented and enforced and that private businesses can thrive within a given legal and regulatory framework, which is not subject to arbitrary political interference. From this perspective, effective governance is independent of the basic character of a political system (the regime type).

Effective governance structures are based on four key principles including accountability, participation, predictability, and transparency, which are required for the sound management of public resources, an enabling environment for the private sector and a productive partnership between the public and private sectors, that does not degrade into closed circles of influence and privilege. Governance provides the overall perspective from which these principles are derived.<sup>32</sup> Capacity building, a term which is often used in combination with governance, refers to the action proposed to achieve these principles (see Box 3)<sup>33</sup>. Confusing these two terms would imply that operationally capacity building

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<sup>31</sup> See Root (1996, 181) for a similar definition.

<sup>32</sup> For a discussion of these principles and the corresponding imperatives for institution building see Root (1995).

<sup>33</sup> *Capacity building* includes three components: (i) institution building (i.e. replacing a less efficient by a more efficient set of rules and functions); (ii) organizational restructuring (i.e. the design of organizational forms better suited to the new set of rules and functions); and (iii) human resource development (i.e. in particular training). Hence, capacity building is not to be confused with a pure training exercise. Capacity is the ability to perform appropriate tasks effectively, efficiently and sustainably. In turn, capacity building refers to improvements in the ability of public sector organizations, either singly or in cooperation with other organizations, to perform appropriate tasks. Beyond the set of irreducible public sector functions such as establishing law and order and setting the rules of the game for economic and political interaction, appropriate tasks are



work in the narrow sense may be interpreted as governance in the broad sense. Thus, each effort at capacity building would be considered a governance activity implying the danger that policy makers do not take the complexity of a governance structure into account, but tend to tackle governance problems in an ad hoc manner.

With respect to problems of initiating, implementing and sustaining government policies, the *political institutions* of a country's governance structure play a dominant role, because they determine how different actors are involved in political processes, what kinds of economic reforms are politically feasible, and how the behaviour of individual actors is shaped. After all, the structure of political institutions shapes the interactions of individuals to determine the outcomes of public policies.

Box 3: <i>Governance and Capacity Building</i>	
Governance	Capacity Building
Accountability	Public Sector Management; Public Enterprise Management and Reform; Public Financial Management; Civil Service Reform;
Participation	
Predictability	
Transparency	
	Participation of Beneficiaries and Affected Groups in Projects; Public-Private Interface; Decentralisation of Economic Functions and Empowerment of Local Government; Cooperation with NGOs; Legal and Regulatory Reform; Legal Framework for Private Sector Development; Disclosure of Information; Stable and Clear Rules of the Game

those defined by necessity, history or situation in specific contexts within a given country (Grindle and Hilderbrand 1995). It is to be noted that training without institution building and organizational restructuring will have no sustainable effect, if the existing institutions do not match with the proposed policies. New capacity is needed to help assure the rule of law and open access to public information. But capacity building also includes the need to ensure that diverse social groups are able to get needed information and participate in the making of public policy. It includes the need for vibrant markets and a private sector that operates in partnership with government.

From the perspective of policy reform, two distinct, though interdependent dimensions of governance structures play a critical role: the first is political relating to the commitment to effective governance and the second is technical relating to capacity building. As Stiglitz (1998a) points out, policy makers can improve their capabilities of undertaking policy reform by reinvigorating state institutions. This refers not only to enhancing technical or administrative capacity but also to instituting norms and rules which provide government officials with incentives to pursue collective ends while restraining arbitrary action and corruption. But what are the appropriate institutional arrangements that align incentives of political officials and citizen welfare? How do governments commit to providing efficient public goods and preserving market incentives? The answers lie in the governance structure of society. For it allows, if effective, societal groups to deal with current problems of policy reform as they arise and yet provides secure political and economic rights (Weingast 1995).

The effectiveness of governance structures in general and political institutions in particular is essentially shaped by the incentive structures they provide resulting from the structural characteristics of states. "Different kinds of state structures create different capacities for action. Structures define the range of roles that the state is capable of playing. Outcomes depend both on whether the roles fit the context and on how well they are executed" (Evans, 1995: 11). In contrast to predatory states, which extract wealth at the expense of society, lack the ability to prevent arbitrary political action, and rely on clientelism and favoritism, developmental states are distinguished by a politico-institutional structure based on the rule by impersonal institutions that makes policy reform a politically feasible option.

Recent studies on the political economy of policy reform show that the complex coordination and collective-action problems associated with policy reform can be mitigated by politically-crafted self-enforcing governance structures. These structures change transaction costs, reduce information asymmetries, stabilise expectations, and prompt political authorities to credibly precommit to abide by rules and regulations and to sustainably promote economic development.<sup>34</sup> Relatively low political transaction costs are

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<sup>34</sup> See, e.g., Campos and Root (1996), Qian and Weingast (1997), and World Bank (1997).

necessary in order to facilitate legislative exchange, to better monitor bureaucratic behaviour, to improve public sector management as well as the interaction of the various branches of government, business representatives, and social groups. In another respect, however, a governance structure to be effective needs to increase political transaction costs. This is particularly important in order to prompt policy makers to credibly precommit to abide by the rules of the game and to enhance the incentive compatibility of public policies and economic performance. In order to create credible limits on their own authority, policy makers need to tie their own hands establishing suitably designed political rules, the revision or transgression of which is associated with high transaction costs. Governance mechanisms which prevent policy makers from acting opportunistically and restrain arbitrary state action include the rule of law, institutional checks and balances through horizontal and vertical separation of powers, an independent judiciary, and effective watchdog organisations.<sup>35</sup>

Institutional mechanisms which help improve public sector management may comprise:

- the introduction of hard budget constraints that help delimit the influence of external actors on government expenditures and measure bureaucrats' ability in macroeconomic management;
- competitive wages for bureaucrats that can attract more talented individuals and increase integrity and professionalism;
- independent personnel agencies which reduce external pressure on appointments and patronage;
- statutory boards partitioning the policy space by assigning single policies to special agencies that help monitor civil servants' performance;
- anti-corruption agencies which reduce bureaucrats' propensity to use their specific information for extra-legal activities; and
- socially connecting an independent bureaucracy through deliberation councils or informal institutions in order to encourage the mutual exchange of information

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<sup>35</sup> See, e.g., Persson et al. (1997), Weingast (1993), Dixit (1996), Root (1996), and Rodrik (1995).

between the public administration and the private sector, enhance the bureaucracy's flexibility, and support a consensual and transparent process of policy formulation.

Besides international competition, it is the organisational design of, and the incentives within, the public sector and the institutions linking the public and private sector that are crucial to the developmental consequences of government policies.<sup>36</sup>

An adequate institutional environment for policy reform needs to provide mechanisms of consensual conflict resolution, enhance political and social stability through transparent rules and processes about how to solve collective problems, and create public trust on the basis of a common sense of legitimate authority.<sup>37</sup> Effective governance structures must be adequate means to adequately adjust political transaction costs and to mitigate the multiple principle-agent problems which are inherent to policy reform. The existence of multi-principle/multi-task agencies embedded in a multiple-level principle agent framework imposes severe restrictions on the formulation and implementation of public policies. These constraints, resulting from imperfect and asymmetric information, difficulties to monitor bureaucratic input and output as well as the activities of private agents, opportunistic behaviour, multiplicity of interests, bounded rationality, and time inconsistency, cause political transaction costs. Instead of imposing additional formal constraints on administrative units, as it is often observed in government bureaucracies (Wilson 1989), effective governance structures need to rely on more sophisticated institutional arrangements with powerful incentive schemes and screening, signaling, and monitoring mechanisms, which imply a fusion of interests of politicians, bureaucrats, business, and non-elites. Furthermore, the quality of governance can be enhanced and incentive-compatibility of public policies and economic performance achieved through a subtle system of checks and balances, separation of powers, delegation of authority, and credible commitment.<sup>38</sup> Hence, governance structures are effective if they create a *strong*

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<sup>36</sup> See Campos and Root (1996), Evans (1995), Qian and Weingast (1995), World Bank (1997), and Stiglitz (1998a).

<sup>37</sup> In this respect, see Keefer and Knack (1997), who find in their cross-country analysis that social capital matters for economic performance. Civic norms and trust are relatively strong in societies with relatively high incomes and equal income distribution, with institutions restraining predatory state action, and with educated, ethnically homogenous populations. They argue that in countries, in which interpersonal trust is relatively low, the provision of formal institutional rules monitoring economic exchange is of particular importance.

<sup>38</sup> See Dixit (1996) and Martimort (1996).

*but limited government*; strong in the sense that it is able to credibly precommit itself to policies, which are in the interests of its constituency, and to establish an independent bureaucracy capable of implementing and enforcing those policies; limited in the sense that both the government and the public administration are prevented from violating citizens' rights and confiscating private wealth and held accountable for their activities. By establishing strong but limited governments, institutions can be designed and incentives created which channel the behaviour of political decision makers into those activities which are compatible with sustained economic development and prompt private business to carry out long-term investment and provide the authorities with information that is necessary to make viable policy choices.<sup>39</sup>

## **5. TOWARD A POST-WASHINGTON CONSENSUS ?**

Policy reform in a complex institutional structure, which itself may be subject to change, has not only an economic, but also a political and social dimension. Neglecting these may lead to theoretically efficient, but—due to non-economical obstacles to reforms—politically not feasible propositions and eventually to, what Myrdal called, opportunistic ignorance (Streeten 1993). Besides the formulation of consistent reform policies, a country's governance structure is the fundamental mechanism which decides upon the success of economic reforms and eventually determines a country's development path. The success in meeting the challenge of development particularly depends on the quality of policy making. Policy reform and high economic growth rates cannot be sustained without continuing institutional change. Therefore, effective governance needs to be interpreted as a dynamic process that requires continuing fine tuning and adjusting institutions and policy solutions to changing technological, social, economic, and political environments. New institutions will only survive and unfold their positive developmental impact if they are supported by individuals and organisations which have a stake in their survival. This requires both a high degree of incentive-compatibility of government policies

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<sup>39</sup> See Weingast (1995), who provides a thorough analysis of the concept of strong but limited government.

and economic performance as well as the creation of flexible institutional arrangements that constitute a stable economic and political order and permit institutional change.

During the 1990s, the view, that the politico-institutional environment has been the primary source of obstacles for sustained economic change, has come to reflect the failures of structural adjustment programs. Problems concerning the adequate institutional design for the formation, implementation, and enforcement of policy reform programs have gradually become seriously analyzed issues in both scholarly debates and the work of international organisations (including the multilateral development banks (MDBs)). The latter, which have usually demanded LDCs and PSCs to radically implement a package of clear and simple adjustment recipes as a precondition to further lending, have come to realise that their policy recommendations have been deficient, but that the necessary change in their programming policies would threaten to overrun their own agenda. Given the governance dimension of policy reform, the MDBs face the dilemma that improving adjustment programs will imply that these organisations take into account that now the nature of political orders of sovereign countries is at stake, any consideration of which would not only exceed their technical expertise but also their mandate.

Nevertheless, governance issues and the need to strengthen institutional reforms in LDCs and PSCs have received considerable attention in different forums:

- LDC and PSC governments themselves have been expressing growing concern with various aspects of poor development management;
- bilateral development agencies are devoting growing attention to using aid effectively, especially to reverse the signs of aid fatigue resulting from the misuse of funds;
- facing the challenge of aid effectiveness, the MDBs<sup>40</sup> are increasingly taking the promotion of effective governance into consideration;
- in 1997, the Executive Board of the International Monetary fund (IMF) adopted guidelines concerning the role of the IMF in governance issues;

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<sup>40</sup> In this context, the MDBs include the World Bank, the Asian Development Bank, the Inter-American Development Bank, the African Development Bank, and the European Bank for Reconstruction and Development.

- United Nation agencies, especially the United Nations Development Programme (UNDP), are increasingly addressing the problem of how to improve governance structures;
- in 1996, the World Trade Organisation Ministerial Conference declared to establish a working group to prepare an agreement to improve transparency in government procurement practices;
- in 1995, the European Union added the promotion of good governance as a central principle for the Union's development policies;
- in 1997, the ad hoc working group on participatory development and good governance established by the Development Assistance Committee of the OECD viewed good governance and democratisation as unalterable prerequisites for sustainable development; it emphasised the role of civil society and the importance of country-level policy dialogue and adequate aid management as central factors in a long-term strategic framework;
- at the Halifax Summit in 1995 and the Lyon Summit, the G-7 countries declared good governance as the foundation of sustainable development;
- in 1996, the Ministers of the Intergovernmental Group of Twenty-Four also discussed governance issues, although they emphasised that the Bretton Woods Institutions should proceed with great caution in applying conditionality in the area of governance;
- during the last ten years, virtually all international organisations and bilateral development agencies called for decisive measures to combat bribery and to fight corruption in international and domestic business transactions; particularly Transparency International, a non-governmental organisation dedicated to increasing government accountability and curbing both international and national corruption, has stimulated the international discussion on corruption in international business transactions since 1995 by annually publishing an international corruption index covering more than 80 countries.

Facing the growing public concern with corruption, misuse of funds, and poor policy making, international organisations have been increasingly urged to give governance

issues a higher priority on the agenda of policy reforms. The World Bank had already started at the end of the 1980s to focus on governance problems and their inherent constraints to policy reform (World Bank 1989). The Asian Development Bank (ADB) was the first of the MDBs, which adopted an official governance policy in 1995. The ADB proposed to integrate governance-related issues into its country operations through the inclusion of suitable policy measures, project components, and technical assistance projects. Today, most multilateral and bilateral donor organisations take the problem of fighting corruption and creating effective governance structures into consideration.

All MDBs claim that they have been involved in promoting good governance for a long time. This has been certainly true with respect to governance issues related to specific projects.<sup>41</sup> But essentially, governance work has been carried out in an ad hoc manner. All MDBs have lacked a coherent and consistent approach to address key governance issues. To date, none of them has provided a coherent concept suitable to establish an overall governance strategy for a particular country. Moreover, promoting effective governance by the MDBs and the IMF needs to take future political and social consequences into consideration which result from recommended policy adjustment packages. Ignoring these consequences may imply that economically efficient programs may turn out to be counterproductive, if existing governance structures are weak or if social and political side conditions are inappropriate to effectively implement adjustment packages. International donor organisations need to explore suitable ways to reduce the number of cases in which anticipated reform success evolves into unexpected and expensive failures.

The treatment of the Indonesian crisis in 1997/98 by the IMF is a case in point. Through the imposition of an orthodox austerity approach cum financial sector restructuring, the Fund unintentionally contributed to worsening the crisis. Regardless of whether or not the recommended policies were appropriate from a theoretical point of view, it must be argued that potential country-specific social and political reactions to policy reforms need to be taken into account in order to ensure the feasibility of reforms and to maintain political stability.<sup>42</sup> For policy actions not reflecting the views of broad societal

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<sup>41</sup> This essentially relates to the institutional strengthening of, and capacity building at, a particular ministry or agency as one component of a specific project in a particular sector.

<sup>42</sup> Regarding the role of the IMF in the Indonesian crisis see, e.g., Radelet (1998) and Radelet and Sachs (1998). For the most comprehensive list of references concerning the Asian financial and



groups can imply social and political disruptions which seriously interfere with the functioning of the economy. Therefore, both domestic experts in policy making and international organisations need to take the costs of those disruptions into consideration, even if the social and political ramifications may not be explicit parts of their objective functions. From a governance perspective, the application of standard adjustment programs based on allegedly even-handed policies cannot be effective. The Fund's envisaged approach to governance, which still lacks a proper definition of the term, is restricted to governance-related problems in public resource management and (financial) market regulation. Instead of seeking a theoretical foundation and applying it to country-specific circumstances, the IMF is looking for best practices as a basis for developing new standards to be evenly applied across countries. Notwithstanding the importance of standards in technical areas such as data dissemination as well as fiscal and banking codes, macro- and microeconomic policy recommendations need to be tailored to the needs, capacities and capabilities of individual countries. If these requirements cannot be fulfilled by the Fund be it for a lack of expertise or a restricted mandate of the organisation, then the IMF should consult and cooperate more closely with the MDBs and other international organisations, when it designs adjustment programs.

Only recently, leading policy makers and economists have begun to call for a new coherent paradigm for economic and social development. Within the donor community, the most prominent proponents of a post-Washington consensus have been James Wolfensohn, President of the World Bank, and Joseph Stiglitz, the Bank's Senior Vice President and Chief Economist. The World Development Report 1997 was a milestone in revising the political paradigm for development of the World Bank, the starting point of a new, more productive dialogue between the Bank, other political decision makers, academics, and civil society. Stiglitz (1996 and 1998a), in particular, advocates in favour of developing and using more policy instruments to pursue broader objectives of development including sustainable, egalitarian, and democratic development. He argues that the new paradigm for development should seek to explore ways of how to effectively achieve an overall transformation of society. A new development strategy should be less prescriptive, though

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economic crisis, the role of the IMF, and particular country analyses, visit the Asia Crisis Homepage on the Internet created by Roubini (1999).

more comprehensive than the Washington consensus. It needs to give key development issues comprising education, health and living standards as well as the environment equal priority as GDP growth and capital allocation. Processes and consensus for policy reform need to evolve at all levels of society and should not be imposed in form of abstract prescriptions by outside donor organisations.

However, the debate on a post-Washington consensus is still at the very beginning regarding a discussion on how LDC governments, social groups, and local non-governmental organisations can be supported to develop and improve the capabilities and institutional capacities needed to successfully pursue policy reform. Stiglitz (1998b) identifies five promising propositions in this regard:

- (1) Government interventions should be restricted in areas which are subject to a significant and systematic influence of special interest groups;
- (2) a crucial government role is to promote competition and to act as a referee in a market economy;
- (3) in order to improve government performance, political decision-making processes need to become more open and less subject to secrecy;
- (4) governments need to encourage the provision of public goods by the private sector in order to discipline itself and to convey voice; and
- (5) political authorities should aim to achieve a balance between the technical expertise of policy making on the one hand and accountability and democratic representativeness on the other hand.

Greater openness, a public-private partnership, and an increasing number of participants providing inputs on policy making are central factors to bring about more balanced signals reflecting societal preferences. They are also critical to ensure that the government and the private sector act in a complementary fashion. Moreover, inclusive policy-making based on consensual processes shows a higher degree of permanence and enhances the feasibility and efficacy of policy reforms. Competitive advocacy processes represent an appropriate means to openly discuss opposing arguments. They advance the consideration of costs and benefits related to specific policies in a more balanced manner.

Of course, notions of how to redefine the role of government in economic development and how to make it more effective and accountable need to be incorporated in a new paradigm for development. But how should governance issues be coherently and consistently included in the emerging new paradigm? In this regard, neither the literature on policy reform and development nor discussions among development practitioners have provided the answer. Besides the political sensitiveness of the issue, it is the difficulty of operationalising any concept of governance which imposes new challenges on the development community. Eventually, turning good intentions into action and developing new adjustment programs that may imply a post-Washington consensus is associated with serious problems:

- governance is a politically sensitive area, and donor organisations need to ensure that LDC and PSC governments can assume ownership of governance-related programs;
- in order to formulate a consistent governance strategy tailored to the needs of a borrowing country, the MDBs must establish internal consensus building mechanisms to deal with persisting diverse interests and convictions within their management; in addition, they need to seek rules and procedures to overcome external political and commercial pressures on their programming activities;
- international development organisations such as the World Bank or the regional development banks need to develop a coherent governance policy on which their operations will be based;
- in order to implement this policy, these organisations must develop an adequate technical expertise;
- since development agencies perform different roles and have different mandates, a concerted action of multilateral and bilateral agencies seems to be necessary to develop coherent program strategies and to achieve the desired results.

Experiences show that institutions, policies as well as the design of the economic and political order are of utmost importance for successful policy reform. This fact is encouraging in so far as it allows to conclude that less successful countries should be

basically capable of overcoming the impediments to development. But this requires that governments of these economies as well as authorities of industrialised countries and multilateral financial organisations are ready to take advantage of existing options to development. However, in designing new adjustment programs policy makers should bear in mind that

“it is entirely possible that neither interest-based explanations nor institutional ones will be entirely satisfactory for explaining how societies cope with the challenges of policy reform and consolidation. Particularly within a democratic framework, consolidation may also require what Kahler calls social learning; the evolution of a broader ideational consensus among leaders, interest groups, party elites and attentive publics that sets some boundaries on the range of economic debate. Such a consensus does not imply stasis or the absence of conflict (...). Nonetheless, it is possible that the long-term sustainability of policy choices will depend on a convergence of thinking about fundamental means-ends relationships in the economy. If so, then the formation of elite preferences, ideas, and ideology, as well as the evolution of public opinion, are potentially important explanatory variables.” (Haggard and Kaufman 1992, 36)

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# **THE TRANSFORMATION OF ECONOMIC SYSTEMS IN CENTRAL AND EASTERN EUROPE: STATE, SOCIETY AND DEVELOPMENT<sup>1</sup>**

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## **1. INTRODUCTION**

The political and economic transformations in Central and Eastern Europe proceed for almost a decade now. The path from a centrally planned to a market economy embedded in a democracy has been long and uncomfortable (see *e.g.* Berglund, Hellén and Aarebrot 1998 and Blanchard 1997). In none of the countries involved, the transformation has been completed (Lavigne 1999). In this article, the desirability of a market economy for sustainable economic growth will not be questioned. However, the paper addresses some of the ideas exposed among scholars with respect to the *process* of transformation. Transformation is all about the transferability of institutions. The question is whether Western models can be transferred to Central and Eastern Europe and, if so, do they function in a similar way.

Given the problems involved with the transferability of institutions, it is of extreme importance to be careful in drawing lessons for other regions in the world, such as Africa.<sup>2</sup> Two major problems appear with a comparison between Central and Eastern Europe and Africa. Firstly, even if it were possible to transfer institutions from one place to another, it remains highly questionable whether it would enhance similar behaviour of the institutions and the agents confronted with them. The experience of Central and Eastern Europe has

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<sup>1</sup> This paper is a revised version of the one presented at the workshop 'State, Society and Development: The lessons for Africa', which was organised by the Centre for Development Studies (December 1998). Comments of the participants were highly appreciated, especially those of Niels Hermes. Of course, the usual disclaimer applies.

<sup>2</sup> The purpose of the workshop was to draw lessons for Africa.

shown that behaviour substantially deviated from the Western examples. Apparently, there is no such thing as institutional design (see Elster, Offe and Preuss (1998)). Secondly, Central and Eastern Europe is not Africa. That holds for the level of economic development, the level of education, et cetera. Basically, the problem pinpoints the fact that development should be distinguished from transformation. Of course, this statement is controversial and focuses on the definition of transformation. Theoretically speaking, one could argue that all regions and/or countries are transforming from one system to another. There will always be an endless adjustment of political and economic systems. That interpretation would make transformation a meaningless phrase. Last decade's developments in Central and Eastern Europe, however, may be called unique, since both democratisation and market reforms were implemented more or less simultaneously and both were far-reaching and comprehensive. It did not only involve the relative autonomous process of organic development, but also largely implied a purposeful attempt to shift from one system to the other. Therefore, there are appropriate arguments to distinguish between Central and Eastern Europe, on the one hand, and Africa, on the other. As far as a comparison with Africa is concerned, one is perhaps able to pinpoint the failures in the Central and Eastern European Transformation. The extent to which can be learned from these experiences maybe rather limited, since both the initial conditions and the defined policy goals in the two regions are too diverse.

The topic of this paper focuses upon the role of the state for the countries in Central and Eastern Europe, which since 1989 have tried to implement a market economy embedded in a democratic political order. Due to the problems that emerged after the introduction of transformation strategies, it is now common knowledge that the state is important. That was not the case in 1989. It was common sense that the state should withdraw. The pivotal questions addressed below are *'Why is it that for transforming an economy one needs a powerful state and what are the conditions to be fulfilled in order to have a powerful state?'*

The outline of the paper is as follows. Firstly, the topic of transformation will be addressed. What are the basic ingredients, what are the concepts for transformation and why did transformation in Central and Eastern Europe appear to be so difficult? Secondly, the question to what extent institutions can be transferred is a political issue. In 1989, there was

strong political support for system change. However, the functioning and the performance of the new system deviated from its Western examples. The performance was highly dependent upon political, economic and cultural legacies. What does this imply for political reform? Does political reform weaken the possibilities for economic reform? Do we have to perceive political reform as a constraint for economic reform and conclude that the 'East' will become the new 'South' or can democratisation enable and facilitate economic reform? Thirdly, the role of the state in the creation of a market economy will be examined. It will be argued that a powerful state is most important, not only during the transformation but also afterwards. Fourthly, the paper intends to scrutinise the necessary conditions for a strong state. In that context, it focuses particularly upon the necessity of a 'civil society'. A 'civil society' is functioning at the intermediate level in society. It is not the state, neither is it the individual. It will be tried to explain that a well-functioning 'civil society' is a *conditio sine qua non* for the well-functioning of the state. Fifthly, the paper will conclude with some remarks for the discussion on research with respect to state, society and development.

## **2. RECONSIDERING THE THEORETICAL UNDERPINNING OF ECONOMIC TRANSFORMATION**

The end of communism in Central and Eastern Europe took scholars by surprise. Nobody did foresee the collapse of the Soviet-system. *Ex post factum*, it is easy to explain why the system had to fail, but *ex ante* the theoretical feasibility was no issue. Socialism existed (see e.g. Lavigne 1999: 91ff). It was the '*real existierende Sozialismus*'. This system had its *pros* and *cons* and where it had disadvantages, the system needed to be reformed not transformed. As a matter of fact, one was impressed by the stability of the system. Subsequently, when the '*iron curtain*' fell, and communists were forced to change their comfortable seats behind the government table for the wooden chairs of opposition, nobody knew how to tackle the problem of transformation. There were no historical precedents upon which to rely, neither was there a theory on which to draw general guidelines for the creation of a market economy. Why is there no theory?<sup>3</sup>

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<sup>3</sup> The remainder of this section heavily draws on ideas expressed in Hoen (1998), chapter 1.

There has been a debate upon the speed and sequencing of reforms — the '*shock-versus-gradualism debate*' — but this led to entanglement. Scholars fuelled this confusion, since proponents of '*shock*' or '*gradual*' treatment emphasised different elements on the agenda of transformation. Adherents of a shock-approach merely focused upon stabilisation and liberalisation. The arguments were clear and need not be elaborated here in detail. Of crucial importance was the implementation of a restrictive monetary and fiscal policy combined with a complete liberalisation of prices, production and (international) trade. Those in favour of a more gradual strategy did not only emphasise the desirability of a less restrictive stabilisation and liberalisation policy, but first and foremost underlined the fact that a full-fledged market economy needs institutions to guarantee freedom of contract, liability and competition. These institutions can partly be designed and implemented, but they are also the result of a lasting evolutionary process.

It can be concluded that participants in the debate focused upon different aspects of the agenda on transformation. Therefore, it is important to note what one is talking about, since the labels given to the strategies that were applied do not take the different aspects of the agenda into consideration. In the literature, stabilisation and liberalisation have become decisive for qualifying the strategies, whereas micro-economic restructuring and institution building did not have a major impact on the type of the label. For example, Hungary has always been presented as a country following a gradual path of transformation, that is, building upon the reforms implemented in the 1980s. In terms of stabilisation and liberalisation, there seem to be sound arguments to qualify the Hungarian transformation as gradual (Hare and Révész (1992)). However, when looking at institution building the arguments are no longer valid since the country implemented for example far-reaching bankruptcy policies, which were unknown in other countries in the region. Poland is another example in case. It has always been earmarked as the classic example of shock treatment (Sachs 1993). When perceiving the speed of stabilisation and liberalisation, this seems to be justified, but when looking at privatisation it is far from true.

The fact that stabilisation and liberalisation have been dominating the qualification of strategies is no coincidence. Scholars in favour of '*shock treatment*' were educated in a neo-classical tradition and this school of thought dominated the discussion from 1989 onwards. In neo-classical thinking, the transformation to a market is a matter of immediate adjustment of rational subjects. The only institution that is included in the analysis is the

market and this market is assumed to function fairly well. As a matter of fact, institutions are taken as '*data*'. They do matter, but are not an object of study. With respect to the transformation in Central and Eastern Europe, this view implied that institutions are taken as '*unnatural restraints*'. In other words, a market economy is that what a centrally planned economy is not and, therefore, the dissolution of all the institutions belonging to the organisation of central planning will automatically lead to a market economy. Systems are '*reversible*' and '*path-independent*'. The static nature of neo-classical economics, or more precisely, the comparatively static way of analysis, places the economist in the chair of God. He said, '*Let there be market, and see there was market and he beheld that market was good*'. In other words, transformation from central planning to a market economy is a matter of institutional design.

The economists who underline the importance of institutions and who tend to be more in favour of gradual transformation do stem from more heterodox schools of economic thought. These schools are exposing different ideas, but they do have in common their criticism upon the idea of the market as a reflection of general equilibrium. Whereas neo-classical economists are inclined to address the conditions under which equilibrium will be effectuated, Post-Keynesians as well as Austrian economists are more likely to scrutinise what will happen when these conditions are not met. Not so much the impact of institutions upon economic performance, but rather the way in which institutions behave and change over time is what they focus on. Instead of a non-historic analysis, the disequilibrium concept of the heterodox schools will emphasise '*irreversibilities*' and '*path-dependencies*' (Garretsen 1992). Contrary to the neo-classical approach, the market is not the negation of central planning, but it needs its own institutions. These can partly be designed and implemented, but will also be the result of endless adjustment, since experiences from the past will determine their final outcome (see Wagener 1991). So again, the economists sitting on God's chair said: '*Let there be market, and see there was neither market nor planning, and he beheld that it was endless adjustment by means of selection*'. Following heterodox theory, transformation from one system to the other is a matter of a Darwinistic process of trial and error. Behaviour of economic agents is influenced by experiences from the past. Due to incomplete knowledge, there is a crave for routine action. A changing external environment may induce the drop of certain economic behaviour and,

at the same time, inclusion of another, but it will not do away all at once (see also Nelson and Winter 1982). It goes without saying that such a view has far-reaching consequences for the role of privatisation.

### 3. THE RELATIONSHIP BETWEEN POLITICAL AND ECONOMIC REFORM

The economic transformation in Central & Eastern Europe was unique, since it coincided with political transformation. Due to the fact that the decision to implement harsh economic reform is a political decision, it is important to pay attention to the relationship between political and economic reform. Democratisation as political reform is usually perceived as a restriction for economic reform (see Offe 1991 and Przeworski 1991). Painful economic reforms will erode popular support, which, ultimately, may reverse the reforms once the costs are exceeding a certain threshold.

Economists are inclined to interpret political reforms as restrictions for economic reform. Rolánd (1994) distinguishes two kinds of political constraints: constraints *ex ante* and constraints *ex post*. Political constraints *ex ante* refer to a situation in which compromises have to be made with respect to the economic reform package, because, for example, the communist regimes had already introduced far-reaching reforms. In that case, the authorities have to convince others to join and make clear that, if necessary, there is a way back. There could also be a situation in which there is large political support for far-reaching economic reforms, because of the revolutionary climate. This is what Balcerowicz (1995) called '*extra-ordinary politics*'. Due to a condemnation of all that was associated with communism, there may be an opportunity to have some kind of a '*shock*' to be introduced. This is a '*scorched-earth policy*'. Of course, now the political constraints will be *ex post*. As soon as the negative consequences of such a policy materialise, people may change their mind and want to relax or even reverse the situation.

Again, Hungary and Poland have been taken as examples to illustrate these different political constraints. In Poland, the opposition (*Solidarnosc*) forced the communists to bend their knees, whereas in Hungary, the communists reformed themselves and legalised the establishment of opposition parties even before the system collapsed. After the Hungarian



elections in May 1990, the Antall Government took office. In parliament, there was a rather broad spectrum of political parties, each of them taking care of the interest of their voters. This made it very difficult to introduce shock treatment, since the new government was to be blamed for the negative consequences of such a policy. Already in October 1990, there were massive protests in the form of a Taxi blockade. So, the political restrictions were *ex ante* rather than *ex post* and there was a need to compromise beforehand. In Poland, on the other hand, there was more revolutionary climate, which enabled the Mazowiecki Government to introduce hardship. There was only one goal: '*Demolish all that is related to communism*'. As a consequence, the communists could be blamed for the negative social impact of such a policy. In 1993, so *ex post*, the period of extraordinary politics was over and elections led to dramatic results for *Solidarnosc*. But at that time, there was no way back (see Rolánd 1994).

As indicated above, it is not completely satisfactory to present the Hungarian and Polish transformation strategies in a such a way, since the labels attached to the policies are misleading. They focus on stabilisation and liberalisation and neglect institution building. But other objections can be made as well. The very concept of political constraints is based upon the conviction that democratisation and market reform can only coincide in a society that is stable and highly developed. The validity of these assumptions are often tested by the fact that so many former communist leaders returned into the political arena, the Czech Republic being the only exception to this rule. However, the argumentation is still weak. There may have been a return of communists, but not of communism. In most cases, the return of communists did not coincide with a return of policy. On the contrary, the Horn Government in Hungary implemented IMF-approved stabilisation policy. The same holds true for the election of Kwasniecki as President of Poland. There was no reason whatsoever to fear for a policy change.

The argument might as well be turned the other way around. In Central and Eastern Europe, democratisation was an important stimulus for market reform, since opposition against far-reaching economic reform was dismantled in the sense of being '*de-politicised*' (Bartlett 1997). The Hungarian experience is good example. In the 1970s and 1980s, Hungary appeared to be the brightest shed in the Eastern camp, since it had introduced '*goulash-communism*'. A decentralisation of economic decision-making was introduced

and managers were to maximise profits by responding on the economic regulators, which were determined by the state authorities, such as prices, interest, etc. But ‘goulash-communism’ had one major disadvantage. ‘*Plan-bargaining*’, well known from orthodox communism, was replaced with ‘*regulator bargaining*’. Managers made special arrangements with the Price Office for negotiating better prices, went to the Ministry of Finance for subsidies and cheaper credits, the National Bank for hard-currencies and the Ministry of Foreign Trade for trade licenses (Bauer 1983).

The fundamental idea behind ‘*goulash-communism*’ was a social contract, which was meant to keep the political system as it was and to obtain economic reforms in return: keeping the population quiet in order not to have a repetition of the events in 1956 (Schöpflin 1987). But in terms of economic efficiency, it led to a more intricate system of bargaining. Due to the fact that the political system was maintained, the economic reforms were extremely vulnerable, since the links between the communist party and the important state organs was not demolished. This blockaded an independent function of the latter. The defeat of the communists enabled to ‘*de-politicise*’ state bodies, such as the Price Office, the National Bank, et cetera. The National Bank became an independent central bank, whereas the Price Office turned into an office for competition policy. Therefore, political reform did not restrict but rather facilitated economic reform. It is interesting to make a comparison with the ‘*Prague-Spring*’. Socialism with a human face implied both a political and an economic reform. These had a mutual stimulating effect and could only be halted with military force.

These observations do pinpoint the uniqueness of transformation in Central and Eastern Europe. From the theory of political economy, one would expect obstructions to far-reaching economic reform. As a matter of fact, the reforms in Central and Eastern Europe were quite unlikely to materialise. Market reforms can be perceived as a collective good, with the characteristics of non-exclusiveness and non-rivalry. So the incentives to reform are not clear from such a perspective. Moreover, the distributional effects may have a moderate impact as well. The benefits of reform are for the society as a whole and therefore not that large on a per capita basis, whereas the costs may be quite extensive for certain groups, which, therefore, may be inclined to organise against the reforms (Olson 1965). None the less, economic reforms did materialise. The domestic support for reform

was overwhelming and lasted for quite some time. Herewith, the idea of political constraints is not refuted, but the analysis of what happened in Central and Eastern Europe shows that the restrictions were not effective.

#### **4. THE ROLE OF THE STATE IN THE CREATION AND PRESERVATION OF MARKETS**

It is clear from the analysis above that, acknowledging the fact that transformation has been mistaken for decentralisation, as comes to the fore in the neo-classical theoretical underpinnings of transformation, state intervention is obviously needed. The state is extremely important in the process of implementing institutions and organising privatisation. The fundamentals of a '*slow-but-steady*' approach are that the external environment is the most important task of transformation to arrange, not the fact whether an enterprise is privately owned or not. The state is responsible to guarantee freedom of contract, to enforce contract liability and to introduce and maintain the laws of competition.

The problem of transformation is not so much due to the fact that the state is unwilling to withdraw, but that — as a result of the collapse of communism — it has no clout and, therefore, is unable to design and to implement the new systems. Quite often, it seems powerless and vulnerable to compromise with powerful monopolists. This is completely in accordance with the notion that regulation is most of the time to the advantage of the regulated, which refuels the danger of the emergence of something like the Hungarian case in the 1980s: '*neither planning nor market*'. The need for a strong state can be illustrate with two points. The first point is that one needs a strong state during the transformation process. Taxes may serve as an example. Besides, overcoming the problem of the monetary overhang, the governments in Central and Eastern Europe had to build tax systems as from scratch in order to assure government income. As one may know, the tax system under communism was passive. It was more or less a residual system in which loss-making enterprises were automatically compensated for their losses by means of taking away money from profit-making enterprises. Now, the question is how to build a new tax system (McKinnon 1992). It sounds easy, but it appeared to be extremely difficult

and, currently is one of the major concerns of the *European Bank for Reconstruction in Europe* (1998). The state should organise transparent and general rules, but given its weakness it is not able to do so, since it is enforced to make exceptions, non-general rules, et cetera. Even if the state might be able to introduce legislation and institutions to allow the creation of markets, such as an appropriate tax system, it may lack the authority to enforce obedience to the rules. It was President Harry Truman who once said: '*only two things in life are certain, dying and paying taxes*'. He hurried to add that '*in Russia, only dying is certain*'. In a way, nothing changed really. One of the main problems in the Russian Federation today is the vicious circle of non-paid wages and non-paid taxes. Extrapolating the tax problem to other areas in the transformation, one may conclude that a weak state will generate a system with diffuse property rights. It is well known from the Hungarian experience in the 1980s how inefficient that may be.

The second point focuses on the need for a strong government after the transformation is 'completed'.<sup>4</sup> The ideas which circulated in Central and Eastern Europe right after the collapse of central planning were sometimes quite extreme and, if one may say so, naïve to create a kind of market economy which may never have existed, not even in the nineteenth century. These ideas were completely in line with the non-historic concepts of path-independency and reversibility, as outlined above. It follows from this that for transforming one system into another one needs to get rid of all that is associated with what used to be called the 'Eastern Bloc'. But the markets of the Western examples are to a large extent regulated and, if one wants to say so, 'planned'.

So, a government is not only crucial in the creation of markets, but also in the preservation of markets. The regulation of financial markets is an example in kind (Hermes 1995). Stiglitz (1992: 161) noted that '*if capital is at the heart of capitalism, then well-functioning capital markets are at the heart of a well-functioning capitalist economy*'. However, financial markets are the most complicated and few governments leave them to themselves. There are sound arguments to do so. These concentrate on consumer protection, enhancing the solvency of banks, stabilising the macro-economy and enforcing

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<sup>4</sup> There is an interesting dispute on the question: '*when will transformation be over?*' Suffice it to note in this context that this paper deals with systemic transformation, that is, the departure from a socialist, centrally planned economy, towards a free market. As mentioned in the introduction, it

competition policy. The pure capital market is extremely volatile and may endanger stability and therefore is in need of regulation.

## 5. THE ROLE OF A 'CIVIL SOCIETY' IN THE EMERGENCE OF MARKETS

The powerless state leads to the problems of participation. Many economic agents in Central and Eastern Europe don't care and deny the rules of the newly implemented market. This brings to the fore the question how to empower the state in fulfilling the task of regulating the market. What conditions have to be met in order to have a strong state and how may participation be achieved. This leads to the item of society and the purpose of this section is to address the issue of '*civil society*'. It briefly focuses upon the definition, the extent to which a '*civil society*' was responsible for the collapse of communism and the extent to which the societies are currently '*civil*'.

What is '*civil society*'? To begin with, this is difficult to answer. In the eighteenth century it was interpreted as '*political society*'. It was defined as the capacity of civilians to organise themselves voluntarily independently from any state structure. So, it is something alongside the state. The voluntary aspect is mostly perceived in the context of capitalism. Scottish philosophers like Adam Ferguson thought about civilians as looking after their own interest rather than the public or national interest of the state. Afterwards, the concept of '*civil society*' moved from something that is alongside to something that opposes the state. '*Civil society*' was viewed as '*selforganisation*' against the sovereign, the bureaucratic, or, for that matter, the totalitarian. The concept moved towards a negative definition (see *e.g.* Hall 1996). This was certainly the case among scholars' view about Central & Eastern Europe (Arato 1992 and Szakokochai and Horvath 1992).

Was the end of communism due to a '*civil society*' in Central and Eastern Europe? The affirmative answer is quite popular, but it is doubtful whether it is true. *Ex post factum* it is easy to refer to demonstrations of *Neues Forum* in Dresden, *Solidarnosc* in Gdansk and *Obcanska Forum* in Prague and Bratislava, as it is easy to convince an audience that

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does not necessarily coincide with a transformation from under-development to development, although it is to serve that purpose (see Lavigne 1999),

socialism had to fail after it had collapsed. One could accept this view when talking about the events in Hungary (1956), Prague (1968) or Poland (1980-81). But at the end of the 1980s, both the state and oppositions were rather apathetic. As said above, the system existed and only a small minority within the academic world questioned its stability. As far as the economy was concerned, the same holds true. There was stagnation for a very long time and it is hard to believe that resistance to a shortage economy was due to a 'civil society' (see also Lavigne, 1999, chapter 6). If there was an opposing 'civil society', it was a negative one, which varied from a thinking in terms of 'ich will-hier-aus' in the GDR to an extremely consumer-oriented behaviour in the Hungarian and Polish cases. That was non-participatory opposition. It was 'anti-politics' not 'civil society'.

This leads to the observation that traditions in a society and the extent to which values and norms are compatible with a 'Western culture' are important to be taken into consideration. A well-known analysis of this kind of necessary conditions for the development of modern capitalism is to be found in Weber's *Protestantische Ethik* (1987). In the context of this paper, state, 'civil society' and market are three concepts which can be perceived as more or less autonomous concepts. To what extent is there a 'society' emerging in Central and Eastern Europe which may be called 'civil', in the sense of creating opportunities for groups to organise themselves within a framework of a legal structures that arrange property rights, freedom of contract, liability and competition, so that there is mutual strengthening of state and society. One of the major problems for Central and Eastern Europe is the lack of mutual dependency between the three. Of course, there are huge differences. In the Central European countries — and maybe one could draw a line between Christianity and Orthodox religion — there is an emerging 'civil society', whereas in the Russian Federation the society is completely anti-politics. We already referred to tax-paying behaviour in Russia. The danger is that not paying becomes something that is normal. The anti-state attitude is quite extreme. Given the fact that protection fees have to be paid, the whole system seems to be withdrawn from the state and functions as if it is privatised. The establishment of political parties as a form of 'self-organisation' is another example. In Hungary, and somewhat later in the Czech Republic and Poland due to the fact that these two countries had the legacy of movements rather than parties, there are reasonably well-functioning parliaments, whereas in the more Eastern

countries, politics is still a matter of dictates of a few persons. But even in the Central European countries there have been '*unconventional*' fights between presidents and Prime ministers about what was within their political realm.

With respect to Russia, one should also take the role of the Orthodox Church into account. The border between what is Christian and what is Orthodox has often been put forward in the literature (see Berglund, Hellén and Aarebrot 1998). The Orthodox Church is important in Russia and was able to profit from liberal legislation implemented in 1990. A return to the situation before 1917, in which the Orthodox church was a state church and, therefore, always within the Kremlin, seemed very likely if not inevitable. It is amazing to see how politicians see themselves associated with '*orthodoxy*'. But the church shows ambivalence towards this rapprochement, since it does not want to be associated with economic misery. On the contrary, it tends to distinguish itself by referring to some feeling of nostalgia and soviet-nationalism. 'Orthodox' is synonymous with 'Russian' and 'anti-Western'. So, the church seems to be able to organise itself, but this powerful institution is purely withdrawing from the state.

## 6. CONCLUSION

There are many factors which influence the paths of transformation in Central and Eastern Europe. The foregoing has pinpointed the role of different political and economic legacies of the *ancien régime* and the nature of political constraints. Therefore, it is no wonder that different strategies have been applied and where policies were similar performances repeatedly diverged. What was suitable for one country proved inappropriate for the other. But transformation is also vulnerable to culture.

What conclusions can be drawn from the analysis above and to what extent are there lessons for African development? The very nature of transformation shows the problem of transferring institutions from one country to another. It is not only a matter of maximisation of utilities under certain constraints. Given the preferences of the individuals, one might not expect behaviour to be similar for people living in Eastern Europe, Asia, or Africa. Never the less, the assumption of the *homo oeconomicus* was the

main motive for the fact that economic advice for Eastern Europe very much resembled that for Latin America in 1980s. So, rather than drawing lessons for Africa, the conclusions are better to be restricted to the experiences in Eastern Europe.

The transformation from socialist central planning to a democracy embedded in market economy has been initiated for the one and simple fact that there was a widespread belief that sustainable economic development needs markets. That is not the same as saying that socialism was necessarily to collapse by the end of the 1980s. Unfortunately, the idea of sustainable economic growth facilitated by markets has been mistaken for sustainable development without the state. The leading thread in the paper is rather that economic development needs markets and markets need a strong state.

Another conclusion which can be drawn is that the experience of the transformation in Central and Eastern Europe has shown that a strong state is not necessarily hindered by democracy. The far-reaching and often painful reforms were from a theoretical point of view rather unlikely to happen. Nevertheless they did happen and they also continued after strong the '*honeymoon*' effects following the revolution in 1989 had evaporated. Due to diminishing political support there has been a return of communists, but not a return of communism. In this respect, the experience in Central and Eastern Europe is unique. It is obvious that political constraints are important, but despite hardship they have as yet not been effective. To this has to be added, though, that 'anchoring to the West' may have been important as well. For example, the perspective of becoming a member state of the European Union, facilitated the pursuing of comprehensive domestic reforms. This kind of an 'anchor' is missing in the Russian Federation and other countries of the Commonwealth of Independent States.

Finally, a strong state is conditional upon a participating instead of a withdrawing '*civil society*'. State, society and market are three more or less autonomous concepts, but they are mutual dependent. The experiences from Central and Eastern Europe are such that the hypothesis of a civil society that forced socialism to collapse is likely to be refuted. If there was one, it was a matter of 'anti-politics'. This fact is currently hampering the development of a powerful and regulating state and, therefore, the development of markets. Again, one can clearly recognise the shortcomings of a neo-classical underpinning of transformation.



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<sup>ii</sup> See Corbo and Fischer (1995) and Summers and Pritchett (1993).